

AGENDA ITEM #5.  
April 10, 2007

Action

MEMORANDUM

April 6, 2007

TO: County Council

FROM: Stephen B. Farber, Council Staff Director *SBF*

SUBJECT: Resolution to approve a five-year funding schedule for County agencies' annual required contribution for Other Post Employment Benefits (OPEB)

On March 19 the Management and Fiscal Policy Committee unanimously recommended that the Council approve the subject resolution, which is attached on ©A-B. The Council introduced the resolution on March 27.

The Governmental Accounting Standards Board (GASB) has issued Statement No. 45, *Accounting and Financial Reporting by Employers for Post Employment Benefits Other than Pensions* (OPEB). The benefits involved are chiefly retiree health and life insurance benefits, as distinct from pensions.

Starting in FY08, jurisdictions with more than \$100 million in annual revenue must disclose their liability for OPEB. Most governments now fund these benefits on a pay-as-you-go basis to cover the annual expense for current retirees. The accrual standard in GASB 45 requires disclosure as well of the expense for employees who may one day be entitled to a benefit.

**Fiscal Impact for the Tax-Supported Agencies**

GASB 45 does not require funding the accrued expense, but credit rating agencies expect that AAA jurisdictions like the County will do so. Based on the four tax-supported agencies' current actuarial valuations, full pre-funding of the annual required contribution (ARC) would cost \$240.0 million in FY08. Of this amount, the **additional** cost, apart from the annual pay-as-you-go expense, would be \$159.5 million in FY08.

The resolution before the Council calls for a five-year phase-in of this additional amount, starting with \$31.9 million in FY08. This cost will rise by a larger increment in each of the next four years until it reaches \$187.7 million in FY12. A new actuarial valuation or plan design could change this amount. For a summary of FY08 OPEB costs by agency, see ©19.

Starting in February 2003, when GASB issued exposure drafts, the MFP Committee and the agencies were among the first state and local officials to address this issue. Since then the Committee has received regular updates from the agencies' finance, budget, benefits, and legal staffs. The Committee's most recent update from the Multi-Agency OPEB Work Group was on March 19. The packet prepared for that update contains important background information and is attached starting on ©C.

**The Executive has included the \$31.9 million amount for the first-year phase-in cost in his recommended FY08 operating budget. (The individual agencies also included their share in their own budget proposals.) The April 5 memo from the Executive on ©36-50 outlines the reasons for his position on this issue. The memo describes in detail the four-year history of the County's work and its extensive interactions with the rating agencies.**

On March 27 Councilmember Floreen requested information on how other AAA rated jurisdictions are addressing this issue. The chart on ©51 provides the information that the Finance Department has developed to date. The chart lists Baltimore, Carroll, and Howard Counties as having chosen a five-year phase-in (or less), with Prince George's at 10 years. It also notes the more restrictive provisions, and lower costs, that some other jurisdictions have for retiree health benefits. Finance Director Jennifer Barrett will be present to discuss the chart and respond to questions.

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Resolution No:

Introduced:

March 27, 2007

Adopted:

COUNTY COUNCIL  
FOR MONTGOMERY COUNTY, MARYLAND

By: County Council

Subject: Five-Year Funding Schedule for County Agencies' Annual Required Contribution for Other Post Employment Benefits (OPEB)

Background

1. The Governmental Accounting Standards Board (GASB) has issued Statement No. 45, *Accounting and Financial Reporting by Employers for Post Employment Benefits Other Than Pensions*, which addresses how state and local governments should account for and report their costs and obligations related to Other Post Employment Benefits (OPEB).
2. County agencies (the County Government, Montgomery County Public Schools, Montgomery College, the Washington Suburban Sanitary Commission [WSSC], and the Maryland-National Capital Park and Planning Commission [M-NCPPC]) are required to disclose their OPEB liabilities in their financial statements, starting with the fiscal year beginning July 1, 2007 (FY 2008).
3. In November 2006 the County obtained actuarial valuation information addressing the extent of the County's liability to its retirees for Other Post Employment Benefits as of July 1, 2006. Other County agencies have also obtained, or are in the process of obtaining, similar actuarial valuations. The OPEB reports are subject to a number of actuarial and economic assumptions; these assumptions were generally similar to the assumptions used in evaluating the County agencies' pension fund liabilities.
4. Based on the assumptions and qualifications stated therein, the OPEB reports concluded that, assuming full prefunding, the FY 2008 annual required contribution (ARC) for the County, its tax supported agencies, and the Montgomery County portion of the M-NCPPC is \$240.0 million, and the related actuarial accrued liability (AAL) is \$2.6 billion. The most recent ARC for WSSC is \$19.1 million, and the related AAL is \$200 million.
5. The County has determined that a five-year phase in of the difference between the current pay-as-you-go amount and the ARC would be a responsible approach to pre-funding, and believes that such an approach is acceptable to the rating agencies, which will be evaluating the County's response to the GASB disclosure requirements and its approach to any obligations to current and future retirees for post-employment health and other non-pension benefits.
6. Should the County establish a separate OPEB trust, and should the County adopt a written policy of its intent to phase-in full funding of the difference between the pay-as-you-go contributions and the ARC on an amortized even basis over a five-year period, it would be appropriate for the County agencies to use, in their actuarial valuations, a discount rate higher than their operating investment rate for accounting and budgeting purposes. Absent such a policy, County agencies would be required to record OPEB liabilities in their financial statement of almost twice as much as liabilities required with such a policy.

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Action

The County Council for Montgomery County, Maryland approves the following resolution:

1. The Council is committed to the responsible fiscal management of the County agencies' Other Post Employment Benefit obligations and acknowledges that County agencies intend to establish one or more Trusts, on or before July 1, 2007 if possible, for such purposes.
2. It is the Council's policy intent to fund the difference between the OPEB pay-as-you-go contributions and the annual required contribution, for the tax supported agencies, on an amortized even basis over a five-year period beginning with Fiscal Year 2008.
3. For WSSC and M-NCPPC, it is the Council's policy intent to support WSSC's and M-NCPPC's plans to implement a five-year phase in of the difference between the OPEB pay-as-you-go contributions and the ARC beginning with Fiscal Year 2008, in coordination with the Prince George's County Council.

This is a correct copy of Council action.


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Linda M. Lauer  
Clerk of the Council

**MEMORANDUM**

March 15, 2007

TO: Management and Fiscal Policy Committee

FROM: Stephen B. Farber, Council Staff Director 

SUBJECT: Update – GASB Statement on Other Post-Employment Benefits (OPEB)

This update deals with the response of County agencies to Governmental Accounting Standards Board (GASB) Statement 45, *Accounting and Financial Reporting by Employers for Post-employment Benefits Other than Pensions* (OPEB). The benefits involved are chiefly retiree health and life insurance benefits, as distinct from pensions.

Members of the Multi-Agency OPEB Work Group, who have collaborated very effectively with each other and with the Committee over the past four years, will be present for this update. We will hear from County Finance Director Jennifer Barrett and Controller Karen Hawkins, MCPS Chief Financial Officer Sue DeGraba, M-NCPPC Secretary-Treasurer Patricia Colihan Barney, Montgomery College Director of Financial Operations Ken Mullinix, and WSSC Chief Financial Officer Tom Traber. We will also hear from the Committee's actuarial consultant on this issue, Thomas Lowman of Bolton Partners, Inc.

**Background**

Starting in FY08, jurisdictions with more than \$100 million in annual revenue must disclose their liability for OPEB. Most governments now fund these benefits on a pay-as-you-go basis to cover the annual expense for current retirees. The accrual standard in GASB 45 requires disclosure as well of the expense for employees who may one day be entitled to a benefit.

GASB 45 does not require funding the accrued expense, but credit rating agencies expect that AAA jurisdictions like the County will do so. Full pre-funding for the four tax-supported agencies would cost \$240.0 million in FY08. Ramping up to full funding of this annual required contribution (ARC) over a five-year period would cost \$31.9 million in FY08 above the pay-as-you-go expense and a larger increment each year until full funding is achieved in FY12. For a summary of FY08 OPEB costs by agency, see ©19.

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## **Previous Work by the Committee and County Agencies**

Starting in February 2003, when GASB issued exposure drafts, the Committee and the agencies were among the first state and local officials to address this issue. At the Committee's request, the agencies' finance, budget, benefits, and legal staff met three times in 2003 to develop a common understanding of relevant questions. They also took an important step by obtaining valuations of their retiree group insurance obligations as of July 1, 2003.

On November 28, 2005, the Committee reviewed the agencies' further progress and agreed that the agencies should:

- Update the actuarial valuations as of July 1, 2006.
- Create a trust – effective July 1, 2007 – if the agency has not already done so.
- Assess the costs and benefits of different pre-funding options and make specific recommendations on the extent, timing, and phasing of pre-funding.
- Assess the full range of options for limiting liability, including collective bargaining implications that may vary by agency.
- Use consultant assistance for these tasks that can draw on the growing body of experience from other jurisdictions.
- Provide updates to the Committee at least twice in 2006 and regularly in 2007 until implementation begins on July 1, 2007.
- Design and implement a communications plan to keep agencies, employees, and the public informed of developments on this issue.

The Committee received updates on the agencies' progress on June 26 and November 27, 2006. The latter update included a report from the Work Group and comments from Mr. Lowman. For this first update of 2007, the Committee agreed to focus on several questions:

- Have the agency budgets all included the FY08 phase-in expense outlined above?
- Will trusts be in place at all agencies on July 1, 2007?
- What progress have the agencies made in exploring options for limiting liability?
- What progress have the agencies made in developing a communications plan?

## **Multi-Agency OPEB Work Group Report (March 2007)**

The Work Group report on ©1-12 reflects the continued progress the agencies have made on the issues identified by the Committee. Agency representatives, together with Mr. Lowman, will discuss these issues point by point. His comments are on ©13-18. Key items in the Work Group report and Mr. Lowman's comments include the following:

- The tax-supported agencies all have actuarial valuations as of July 1, 2006. (WSSC's valuation is still in progress.) Attachment C on ©9-10 is unchanged from the November 27 Work Group report. The Annual Required Contribution (ARC) for the tax-supported agencies is \$240.0 million. The Actuarial Accrued Liability (AAL) is \$2.6 billion. (Both figures significantly exceed those developed in the valuations of three years ago.) Mr. Lowman confirms these figures.

- The FY08 budget impact of a five-year phase-in approach for the tax-supported agencies remains \$31.9 million plus \$7.0 million for increased pay-as-you-go costs. The FY08 recommended budgets for MCPS, the College, and M-NCPPC all include the appropriate amount, as does the County Executive's FY08 recommended budget for these agencies and County Government (see ©19). Mr. Lowman supports the five-year phase-in approach. He notes with respect to the M-NCPPC and WSSC budgets that Prince George's County has not yet confirmed its phase-in period.

- The Work Group report notes on ©2 that, as discussed at the Committee meetings on June 26 and November 27, 2006, *"in order for the County agencies to take advantage of the long-term discount rate assumptions used in the valuation processes, the County Council would need to have an adopted written policy of its intent to phase in to full pre-funding over five years. Absent such a written policy, the County agencies would be required to use short-term discount rate assumptions which have generally resulted in a doubling of the Annual Required Contribution and the Actuarial Accrued Liability."*

**The written policy proposed by the Work Group appears in the draft Council resolution on ©11-12. The text reflects the Committee's previous decisions and discussions with the Work Group. I suggest that the Committee review the text, decide on any changes, and transmit it to the Council for approval. (One possible change is to clarify the language in point 1 of the action clause on ©12 regarding the timing for establishing agency OPEB trusts.)**

- With regard to trusts, the Work Group report notes on ©3 that M-NCPPC has a trust in place and that the other agencies are working to establish them by July 1. For details, see Attachment A on ©5-7. Mr. Lowman notes on ©14 that the agencies are progressing well in this area and that the College has expressed interest in participating in the County Government's trust for investment purposes only.

- With regard to options for limiting liability, including collective bargaining implications that vary by agency, see the Work Group's summary of Plan Design Change Considerations on ©5-7. As Mr. Lowman notes, no changes are imminent. In his November 2006 comments, Mr. Lowman suggested that the agencies' benefits be harmonized to a greater extent. Some of the current differences among agencies are clear from the descriptions on ©5-7.

In his current comments, Mr. Lowman suggests that the "Council consider making a clear point about the increasing burden of retiree benefits costs which will crowd out other parts of the budget over the next five years and beyond." To this end, he suggests that "any benefit improvements in either pension or OPEB benefits be amortized over no more than 15 years" rather than the currently-used longer amortization periods, which produce a lower short-term cost. See his comments on ©14-15.

- The agencies continue to work on these issues with extensive help from their actuarial and legal consultants, as the Work Group report notes in detail on ©3-4.

- Until recently the agencies had necessarily focused on actuarial updates, trust creation, and other issues and had not addressed the Committee's request that they "design and implement a communications plan to keep agencies, employees, and the public informed of developments on this issue." The Work Group has started to address communications issues, and as the report notes on ©4 and in Attachment B on ©8, agencies have already taken some specific steps. The task now for all agencies is to develop and implement a clear and consistent approach to communications issues. As Mr. Lowman notes on ©15, this task is challenging.

- Mr. Lowman's comments on ©15-17 provide useful context on other jurisdictions' work in this area, such as Baltimore County's decision to fully fund the ARC in FY08.

### **Further Background Information**

Packets prepared for previous Committee updates on this issue have included extensive background information from credit rating agencies and other analysts.<sup>1</sup> The packet for the November 27, 2006 update also included excerpts from a helpful reference document, the November 2006 report of Anne Arundel County's GASB45 Task Force. The following excerpts from this report are attached:

- On ©20-21, a discussion of alternative trust funding vehicles.
- On ©22-32, a detailed review of options for addressing the county's OPEB liability.
- On ©33-34, a useful glossary of terms.
- On ©35, a January 1, 2006 bulletin on the County's revised policy on employee eligibility for retiree health benefits, including a minimum of 15 years of credited pension service.

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<sup>1</sup> See, for example, the packet prepared for the November 27, 2006 Committee update at [http://www.montgomerycountymd.gov/content/council/pdf/agenda/cm/2006/061127/20061127\\_MFP01.pdf](http://www.montgomerycountymd.gov/content/council/pdf/agenda/cm/2006/061127/20061127_MFP01.pdf)



## MEMORANDUM

March 5, 2007

TO: Management and Fiscal Policy Committee

FROM: Multi-Agency OPEB Work Group

SUBJECT: Update for March 19, 2007 MFP Committee Meeting

The purpose of this memorandum is to provide an update on County agencies' activities related to implementation of Governmental Accounting Standards Board (GASB) Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other than Pensions* (OPEB). Tax-supported agencies impacted by GASB45 and represented on this work group include: the County government, Montgomery County Public Schools (MCPS), Montgomery College (College), and the Montgomery County portion of the Maryland-National Capital Park and Planning Commission (M-NCPPC); the Washington Suburban Sanitary Commission (WSSC) is the only non tax-supported agency participating in the work group.

At the June 26, 2006 Management and Fiscal Policy (MFP) Committee meeting on this subject, the Committee identified areas it would like to be updated on periodically. At the November 27, 2006 MFP Committee meeting, the agencies provided an update on progress in those areas. The current status, including progress since the November 27<sup>th</sup> meeting, is presented below for each area.

### Status Report

- Update the actuarial valuations as of July 1, 2006, three years later than the current valuations.

*At the November 27<sup>th</sup> meeting, all agencies except WSSC had completed the process of obtaining an updated valuation. WSSC's 2006 valuation was being prepared; their information presented was as of June 2005. WSSC's updated 2006 valuation is currently still in the process of being prepared; it has taken longer than originally anticipated to update census data for the valuation. It is anticipated that the WSSC results will be available by late March.*

*Attachment C, which has not changed since the November 27<sup>th</sup> meeting and which is being provided again for the benefit of any new committee members, presents a summary of the latest actuarial valuation results for the tax-supported agencies. Those updated results show that, assuming pre-funding, the Annual Required Contribution (ARC) for the tax-supported agencies is \$240.0 million and the Actuarial Accrued Liability (AAL) is \$2.6 billion. In the 2003 valuation, the pre-funding ARC was \$190.5 million and the AAL was \$1.8 billion.*

- Assess the costs and benefits of different pre-funding options and make specific recommendations on the extent, timing, and phasing of pre-funding.

*As presented in the November 27<sup>th</sup> meeting, the County intends to implement a five-year phase-in approach. At the November meeting, we noted that the rating agencies had indicated that a phase-in approach is acceptable, and that rating agency statements at that time focused on a five year period. Attachment C displays the estimated FY08 budgetary impact of the five-year phase-in approach which is \$38.9 million for the tax-supported agencies.*

*County executive and legislative branch officials have met with all rating agencies as part of the regular fiscal update process, where the agencies expressed particular interest in the County's plans for managing and funding the OPEB liability. Consistent with those presentations, and pursuant to other detailed discussions, the rating agencies' expectations are that the County will be implementing a five-year phase-in approach.*

*The three tax supported agencies submitting their recommended budgets to the County Executive, included in their FY08 submissions the phase-in amount presented to the MFP Committee at the November 27<sup>th</sup> meeting. The County Executive's FY08 Recommended Budget, which will be issued after the date of this report but before the March 19<sup>th</sup> MFP Committee meeting, will include the FY08 phase-in amounts for all tax-supported agencies that were presented at the November 27<sup>th</sup> meeting.*

*It was noted at the June 26, 2006 MFP Committee meeting and in Attachment A of the November 27<sup>th</sup> report, that in order for the County agencies to take advantage of the long-term discount rate assumptions used in the valuation processes, the County Council would need to have an adopted written policy of its intent to phase-in to full pre-funding over five years. Absent such a written policy, the County agencies would be required to use short-term discount rate assumptions which have generally resulted in a doubling of the Annual Required Contribution and the Actuarial Accrued Liability.*

*The work group is in the process of providing the Council Staff Director with proposed language for such a resolution.*

- Create a trust – perhaps effective July 1, 2007 – if the agency has not already done so.

*Attachment A provides an update for each agency on the work related to establishing OPEB trusts. As noted at the November 27<sup>th</sup> meeting, M-NCPPC already has a trust in place. All other agencies are working with legal counsel to have a trust established effective July 1, 2007.*

- Assess the full range of options for limiting liability, including collective bargaining implications that may vary by agency.

*Attachment A provides an update for each agency on the work related to exploring options for limiting liability, which for most agencies has not significantly changed since the November meeting.*

- Use consultant assistance for the tasks that can draw on the growing body of experience from other jurisdictions.

*The agencies continue to work with their actuaries, each of which are providing OPEB consulting and related actuarial services to a number of governments, to address the requirements and options associated with implementation of the OPEB standards. Of the five County agencies represented on the work group, each agency has used one of two firms, Aon Consulting or Mercer Human Resource Consulting, for its FY06 updated valuation. All firms used Mercer Human Resource Consulting for the 2003 valuation process. Each of the agencies is also using one of the firms for its normal health benefits consulting, and for additional OPEB-relating consulting services. These two firms have been represented whenever possible at the work group meetings. In addition, whenever areas of potential inconsistency in valuation methodology have been identified, the two firms have worked together at the agencies' request to try and ensure as much consistency as possible in methodologies. The Council's consultant, Mr. Tom Lowman, attended the last two meetings of the multi-agency OPEB work group and has continued to share, throughout this process, his experiences with other jurisdictions. County agencies and their actuarial firms have also consulted with GASB staff, as necessary, on matters requiring technical clarification.*

*The County agencies have also worked with in-house legal counsel, where applicable. Several agencies have also consulted with outside counsel as part of the creation of a trust. Legal counsels for the tax-supported agencies have also been in communication with each other, to share information learned and to discuss options.*

*As it relates to trust and investment activities, agencies have also coordinated with their investment consultants and managers on matters such as trust options and investment implications, economies of scale and impact on fees, and opportunities for cross-agency contracts.*

*Relating to communications, and as noted below, the County agencies are attempting to incorporate the input of communications consultants on staff with one of our actuarial firms.*

*Throughout the process, representatives of the County agencies have continued to share information and learned experiences with representatives of other Maryland counties implementing GASB45 for FY08.*

- Design and implement a communications plan to keep agencies, employees, and the public informed of developments on this issue.

*The goal of the County agencies is to keep agencies, employees, retirees, and the public informed of developments on this topic, and to try where possible to have a consistent message. Attachment B presents the communication plan recently developed by the agencies.*

*As noted in the November MFP Committee meeting, the agencies' primary focus until that time had been to obtain updated actuarial valuations, begin the process of creation of legal trusts including analysis of options, and identify and consider plan design changes. Currently, the tax-supported agencies are in various stages of drafting and/or issuing communications on this topic. Communications to date have included articles in employee and/or retiree newsletters, and discussions with/presentations to various interested parties.*

*The work group has recently created a communications subgroup, which includes members of the Interagency Benefits Workgroup. The communications subgroup will be working together to begin implementation of the communication plan. The County agencies are also exploring working with communications consulting resources on staff with one of the actuarial firms.*

Representatives from each agency will be present at the March 19, 2007 MFP Committee meeting to answer questions about the material provided.

Attachments

## Status of OPEB Trust Establishment, Plan Design Change Considerations, and Communications

Agency	Trust Establishment	Plan Design Change Considerations
County	<p>The County has created draft legislation to establish an Internal Revenue Code (IRC) Section 115 Trust for OPEB benefits. The Office of the County Attorney drafted the legislation, which was reviewed by outside legal counsel and affected County departments. The legislation is anticipated to be transmitted to the Council in the near future.</p> <p>Currently, IRS guidance is not clear regarding the tax impact of accepting employee contributions into a Section 115 trust. Therefore, the County's intent is to only permit employer contributions, not employee contributions, to be made to the trust, and the legislation reflects this intent. If further clarification is provided by the IRS, an amendment to the trust could be made at that time.</p> <p>The County is currently in the process of developing a Plan Document, and updating/clarifying the adoption agreement(s) to be signed by outside organizations participating in the County's plan.</p> <p>The College has also recently expressed an interest in possibly participating in the County's trust. The County is currently in the process of working with the College to explore that option.</p>	<p>The County worked with our actuary to develop short and long-term plan design strategies, and to cost out the savings associated with such strategies. For the majority of our employees, the implementation of specific strategies could be subject to collective bargaining. Regarding benefits for represented employees, those benefits would be the subject of collective bargaining. Regarding the OPT/SLT MCGEO bargaining units and the Police FOP bargaining unit, the parties tentatively agreed to a reopener (pending Council approval) scheduled to begin in September 2007. No agreed to or arbitrated changes could take effect prior to July 1, 2008. For the Fire IAFF bargaining unit, negotiations for a successor collective bargaining agreement are scheduled to begin in November 2007. No agreed to or arbitrated changes could take effect prior to July 1, 2008.</p>

# Status of OPEB Trust Establishment, Plan Design Change Considerations, and Communications

<b>MCPS</b>	<p>MCPS presented a draft amendment to the current pension trust document to the Board of Education Audit Committee on February 20, 2007. The amendment creates a "Master Trust" that contains two component trusts for pension and OPEB benefits. Each component trust would satisfy the exclusive benefit rules whereby assets under each can only be used for participants therein. By using this approach, MCPS will take advantage of the favorable investment contracts it has already negotiated for the pension plan, provide common investments, use the same investment committee, and simplify administration.</p> <p>The Board of Education will consider a resolution to approve the Trust Amendment (effective July 1, 2007) at its March 13, 2007 meeting.</p>	<p>MCPS made significant changes to the benefit plan offered to retirees in 2002. Retirees pay 36 percent of the plan cost while MCPS pays 64 percent. MCPS mandates that Medicare eligible retirees enroll in Medicare, and are covered by a Medicare supplement plan or an HMO. The point-of-service plans are not available to Medicare eligible retirees. MCPS changed its prescription drug plan in 2002. Co-pays were increased, and use of generic drugs and mail order pharmacy for purchasing maintenance medications was made mandatory.</p> <p>MCPS is working with the unions and retiree association to review plan design in the context of the GASB funding challenge.</p>
<b>College</b>	<p>The College is working toward the establishment of a trust for FY08. More recent discussions have resulted in additional consideration to further investigate the possibility of whether the County Government's trust document can be written to include language that may allow the College to ride their trust agreement.</p>	<p>The College is evaluating ways to change the eligibility criteria for retiree group insurance benefits (i.e., make it more restrictive). Currently, employees that have worked 5 years are eligible for retiree group insurance; the College contributes 40% of the premium and the retirees contribute 60% of the premium. Employees that have 10 years of service or more are eligible for retiree group insurance, where the College contributes 60% of the cost of the premium and the retiree pays 40% of the premium. The College reviews all of the group insurance plans annually and makes changes to specific plan provisions to meet budget guidelines. Additionally, we will be participating in a bid process with the other County agencies this year and an overall review of the plans will be part of this process.</p>

## Status of OPEB Trust Establishment, Plan Design Change Considerations, and Communications

M-NCPPC	M-NCPPC has a trust in place with a balance of approximately \$130,000. We are discussing with an outside law firm a review of this trust to assure that it still meets all requirements. We are also examining changing governance from the current small board to the same trustees that make up the Pension (Employees' Retirement System) Board.	M-NCPPC had a study of Retirement Health Insurance benefits done in June 2006 by Aon Consulting. This study compared benefits of the Commission with Montgomery and Prince George's County Governments, Montgomery County Public Schools, Montgomery College and Washington Suburban Sanitary Commission. Based on that study, and consistent with the November report, a Commission committee is reviewing possible plan design changes. However any proposed changes must first be reviewed and approved by the Commission. Amendments that legal counsel determines fall within the scope of collective bargaining will then need to be agreed upon with respective union representatives.
WSSC	Outside Counsel has advised that WSSC has the legal authority to establish a trust and is currently drafting a Section 115 trust document for Commission review and approval.	Many jurisdictions are looking at revising their plans to pro-rate the employer subsidy based upon years of service at time of retirement. The Commission has already implemented such a cost sharing formula for retiree health, with 20 years of service required to receive the full employer subsidy. Also, several years ago, the Commission reduced the employer subsidy for all health plans from 85% to 80%. Additionally, the cost sharing percentage for the Point-of-Service plan, in which most retirees participate, was further reduced to 78%. We have also increased co-pays in recent years and continue to annually review plan design for further cost containment.

## OPEB COMMUNICATIONS PLAN

Stated Goal is to "Keep agencies, employees, and the public informed of developments on this issue," and to have a consistent message.

### Interagency Communications Plan:

- Agencies should identify appropriate communication mechanisms (web sites, newsletters, etc.)
- Communication mechanisms should have a consistent message
- Each agency posts OPEB/GASB45 information on its web site for easy access by employees and the public
  - Preferably come to agreement as to how/where it appears
  - Part of financial, human resources, or main page highlight ("what's new"?)
- Web sites should have common elements
  - FAQs (with as many common definitions and explanations as possible)
  - Actuarial valuations should be posted
  - Status reports on activities
  - Financial impact information
  - Incorporate Council perspective/resolutions/etc.
- Explain the WHYs
  - Why OPEB disclosure is important
  - Why we have to not only comply with disclosure, but also fund the obligation
  - Why we are setting up trusts
  - Why considering benefit plan changes is appropriate
  - Why it is important to employees
  - Why it is important to citizens/taxpayers
  - Cause and effect relationships – additional benefits flow into the actuarial calculations and require more funding. Scarcer resources for salaries. It's all related.

### Suggested Actions:

1. Identification of single point of contact within each agency
2. Identification of appropriate communication mechanisms
3. Subgroup drafts common descriptions and FAQs
4. Contacts obtain input from others in respective agency
5. Obtain input from legal counsel and public information, as appropriate
6. Notify labor unions, as appropriate
7. Finalize common materials for all to use
8. Individual agencies post to web sites and incorporate to other communication mechanisms



**OPEB**  
**Actuarial Valuation Results and Key Assumptions**  
**MFP Committee Meeting - March 19, 2007**

	County	MCPS	College	M-NCPPC <sup>(7)</sup>	Subtotal Tax-Supported Agencies	WSSC <sup>(3)</sup>
<b>Results - Incremental Cash Required for FY08:</b>						
<b>Full Prefunding (ARC):</b>						
Normal PayGo increase - FY07 -> FY08 <sup>(9)</sup>	\$ 1,480,790	\$ 4,997,418	\$ 180,000	\$ 320,550	\$ 6,978,758	\$ -
Additional cash required to fund ARC	70,100,000	80,300,000	3,032,000	6,052,500	159,484,500	9,712,000
Total additional cash required	<u>\$ 71,580,790</u>	<u>\$ 85,297,418</u>	<u>\$ 3,212,000</u>	<u>\$ 6,373,050</u>	<u>\$ 166,463,258</u>	<u>\$ 9,712,000</u>
<b>5-yr Phase-in Above PayGo - First Year:</b>						
Normal PayGo increase - FY07 -> FY08 <sup>(9)</sup>	\$ 1,480,790	\$ 4,997,418	\$ 180,000	\$ 320,550	\$ 6,978,758	\$ -
1/5 phase in to the ARC	14,020,000	16,060,000	606,400	1,210,500	31,696,900	1,942,400
Total	<u>\$ 15,500,790</u>	<u>\$ 21,057,418</u>	<u>\$ 786,400</u>	<u>\$ 1,531,050</u>	<u>\$ 38,675,658</u>	<u>\$ 1,942,400</u>
ARC as % of PayGo <sup>(5)</sup>	3.18	2.87	2.21	3.16		2.03
Actuarial Accrued Liability (AAL) <sup>(6)</sup>	\$1,100,530,000	\$ 1,299,000,000	\$57,800,000	\$ 94,695,750	\$2,552,025,750	\$ 200,000,000
<b>Assumptions</b>						
Discount Rate, assuming Full Prefunding <sup>(1)</sup>	8%	7.50% <sup>(2)</sup>	8%	7.50% <sup>(2)</sup>		8%
Actuarial Method	Projected Unit Credit Cost	Projected Unit Credit Cost	Projected Unit Credit Cost	Projected Unit Credit Cost		Projected Unit Credit Cost
Amortization Method	Level % of Pay	Level % of Pay	Level % of Pay	Level % of Pay		Level %
Medical Cost Trend Rate (post 65)	10% -> 5%	10% -> 5.25% <sup>(8)</sup>	10% -> 5%	10% -> 5%		13% -> 5.5%

**NOTES:**

**Council Policy Action**

- (1) Under a multi-year phase-in scenario, use of discount rate higher than operating investment rate (~ 4%) for accounting and budgeting purposes assumes that the County Council will have an adopted written policy of its intent to phase-in full funding of the incremental difference between PayGo and the ARC on an amortized even basis over a specific number of years (i.e., 5) beginning in FY08. Absent such a policy, County agencies would be required to record OPEB liabilities in their financial statement of almost twice as much as liabilities required with such a policy.

**Differences Between Agencies**

- (2) Agency rate is lower than County rate, since agency has used a rate consistent with its pension plan, which is lower than County's pension plan rate.  
 (3) WSSC valuation is as of June 2005, prepared in March 2006; updated valuation not yet prepared.  
 (4) WSSC used Level Dollar amortization method, which would result in higher costs than the Level % of Pay method.

**Other**

- (5) PayGo for this calculation includes Implicit Rate Subsidy Per Bolton Partners, Inc. 7/19/2006 GASB45 Survey range of ratio for 8 Maryland counties is 2.96 - 4.07. State of MD is about 3.2.  
 (6) AAL is based on full prefunding.  
 (7) M-NCPPC valuation is for Montgomery and Prince George's Counties combined. This analysis assumes 45% relates to Montgomery County.  
 (8) MCPS medical cost trend represents an average across medical and prescription.  
 (9) Assumes there will be a policy decision at the agency level to dedicate Medicare Part D subsidies to fund OPEB costs.

**OPEB**  
**5 Year Phase-In Calculation - and Assumed Sources of Funding**

5-Year Phase-In Calculation	Ref	County	MCPS	College	M-NCPPC - (PG & MC)	Mont City Portion of M-NCPPC (1)	Subtotal Tax-Supported Agencies	WSSC (3)
Full Prefunding (ARC)								
Less: FY08 benefit payments	B+C+D	\$ 102,320,000	\$ 123,300,000	\$ 5,532,000	\$ 19,669,000	\$ 8,851,050	\$ 240,003,050	\$ 19,112,000
Less: Implicit Rate subsidy	E	26,720,000	43,000,000	2,500,000	4,919,000	2,213,550	74,433,550	9,400,000
Equals: Additional FY08 funding required for ARC		5,500,000	-	-	1,300,000	585,000	6,085,000	-
		\$ 70,100,000	\$ 80,300,000	\$ 3,032,000		\$ 6,052,500	\$ 159,484,500	\$ 9,712,000
1/5 Phase-In Amount	A	\$ 14,020,000	\$ 16,060,000	\$ 606,400		\$ 1,210,500	\$ 31,896,900	\$ 1,942,400
		\$ 730,000	\$ 2,900,000	\$ 150,000		\$ 135,000	\$ 3,915,000	\$ -
		5,500,000	-	-		585,000	6,085,000	-
		24,509,210	35,102,582	2,170,000		1,758,000	63,539,792	9,400,000
		1,480,790	4,997,418	180,000		320,550	6,978,758	-
		14,020,000	16,060,000	606,400		1,210,500	31,896,900	1,942,400
		\$ 46,240,000	\$ 59,060,000	\$ 3,106,400		\$ 4,009,050	\$ 112,415,450	\$ 11,342,400

**FY08 Total Contribution Towards ARC by Funding Source**

Medicare Part D subsidy (2)	D	\$ 730,000	\$ 2,900,000	\$ 150,000		\$ 135,000	\$ 3,915,000	\$ -
Implicit Rate Subsidy	E	5,500,000	-	-		585,000	6,085,000	-
FY07 PayGo	B	24,509,210	35,102,582	2,170,000		1,758,000	63,539,792	9,400,000
Additional Cash Required for FY08 Benefits	C	1,480,790	4,997,418	180,000		320,550	6,978,758	-
Additional Funding for the ARC	A	14,020,000	16,060,000	606,400		1,210,500	31,896,900	1,942,400
Total - FY08 ARC		\$ 46,240,000	\$ 59,060,000	\$ 3,106,400		\$ 4,009,050	\$ 112,415,450	\$ 11,342,400

**NOTES:**

- (1) M-NCPPC valuation is for total plan, which includes Montgomery and Prince George's employees/costs. Per AI M-NCPPC, Montgomery County portion is approximately 45%. ARC amounts and benefit payments per the actuary, under full prefunding scenario, have been adjusted in this column to reflect 45% of amount in the actuarial valuation.
- (2) Assumes there will be a policy decision at the agency level to dedicate Medicare Part D subsidies to fund OPEB costs.
- (3) WSSC benefit payments represent payments for FY06. Valuation to be updated.
- (4) WSSC information not yet available.
- (5) WSSC valuation is as of June 2005, prepared in March 2006; updated valuation not yet prepared.

Resolution No:

Introduced:

March XX, 2007

Adopted:

March XX, 2007

COUNTY COUNCIL  
FOR MONTGOMERY COUNTY, MARYLAND

By: County Council

Subject: Resolution XX-XXXX Regarding Council's Intent To Phase-in Full Funding Of The County Agencies' OPEB Annual Required Contribution Over A Five Year Period Beginning In FY2008

Background

1. The Governmental Accounting Standards Board (GASB) has issued Statement No. 45, *Accounting and Financial Reporting by Employers for Post-employment Benefits Other than Pensions*, which addresses how state and local governments should account for and report their costs and obligations related to Other Post Employment Benefits (OPEB).
2. County agencies (the County, Montgomery County Public Schools, Montgomery College, the Washington Suburban Sanitary Commission [WSSC], and the Maryland-National Capital Park and Planning Commission) are required to disclose their OPEB liabilities in their financial statements, starting with the fiscal year beginning July 1, 2007 (FY08).
3. In November 2006, the County obtained actuarial valuation information addressing the extent of the County's liability to its retirees for other post employment benefits as of July 1, 2006. Other County agencies have also obtained, or are in the process of obtaining, similar actuarial valuations. The OPEB reports are subject to a number of actuarial and economic assumptions; these assumptions were generally similar to the assumptions used in evaluating the County agencies' pension fund liabilities.
4. Based on the assumptions and qualifications stated therein, the OPEB reports concluded that, assuming full prefunding, the 2008 annual required contribution (ARC) for the County, its tax supported agencies, and the Montgomery County portion of the Maryland-National Capital Park and Planning Commission, is \$240.0 million, and the related actuarial accrued liability (AAL) is \$2.6 billion. The most recent ARC for WSSC is \$19.1 million, and the related AAL is \$200 million.
5. The County has determined that a five year phase in of the difference between the current pay-as-you-go amount and the ARC would be a responsible approach to pre-funding, and believes that such an approach is acceptable to the rating agencies, who will be evaluating the County's response to the GASB disclosure requirements, and its approach to any obligations to current and future retirees for post-employment health and other non-pension benefits.
6. Should the County establish a separate OPEB trust, and should the County adopt a written policy of its intent to phase-in full funding of the difference between the pay-as-you-go contributions and the ARC on an amortized even basis over a five year period, it would be appropriate for the County agencies to use, in their actuarial valuations, a discount rate higher than their operating investment rate for accounting and budgeting purposes. Absent such a policy, County agencies would be required to record OPEB liabilities in their financial statement of almost twice as much as liabilities required with such a policy. //

Action

The County Council for Montgomery County, Maryland approves the following resolution:

1. The Council is committed to the responsible fiscal management of the County agencies' other post employment benefit obligations and acknowledges that County agencies intend to establish one or more Trusts, on or before July 1, 2007 if possible, for such purposes.
2. It is the Council's policy intent to fund the difference between the OPEB pay-as-you-go contributions and the ARC, for the tax supported agencies, on an amortized even basis over a five-year period beginning with Fiscal Year 2008.
3. For WSSC, it is the Council's policy intent to support WSSC's plan implement a five-year phase in of the difference between the OPEB pay-as-you-go contributions and the ARC beginning with Fiscal Year 2008, in coordination with the Prince George's County Council.

This is a correct copy of Council action.

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Linda M. Lauer  
Clerk of the Council

March 9, 2007

**TO:** Management and Fiscal Policy Committee  
**FROM:** Thomas Lowman, Bolton Partners, Inc. *TL*  
**SUBJECT:** Comments on the Multi-Agency OPEB Work Group Report

This memo is an update to our prior memo dated November 20, 2006. We have moved some of the background material to the end of this memo and have focused on changes and progress made since the MFP Committee meeting in November.

We attended the recent meeting of the Multi-Agency OPEB Work Group and reviewed the March 5<sup>th</sup> update that they prepared. The March 5<sup>th</sup> update addressed areas on which the MFP Committee asked them to comment. Below are our comments on each of these seven areas requested by the MFP Committee, taking into account information presented by the Work Group:

- 1. Update the actuarial valuations as of July 1, 2006, three years later than the current valuations. This will allow adjustments for those current cost figures and for changes such as the inception of the new Medicare Part D prescription drug benefit.**

Nothing has changed from what was reported in November as this was largely completed by the November meeting. The estimate of the increase in the funding requirement for FY08 if the GASB45 expense were fully funded remains at \$159 million (for tax supported agencies). The \$159 million excludes the \$7.0 million increase that will occur even without the new accrual accounting rules. The total year over year increase would be \$166 million.

The only outstanding issue is the completion of an updated valuation for WSSC.

- 2. Assess the cost and benefits of different pre-funding options and make specific recommendations on the extent, timing, and phasing of pre-funding.**

We are on the same path we were in November. The plan is to eventually fund the full accrual expense for these benefits but to do this over a five-year period starting with FY08. This would mean that the FY08 budget increase would be \$38.9 million instead of the full \$166 million.

At the meeting I attended it appeared that Prince George's County had not settled on a phase-in period yet. The group is going forward assuming that either Prince George's County will adopt/support a five-year period for the MNCPPC and WSSC budgets or there will need to be an adjustment so that both counties adopt a common approach for these two agencies.

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3. **Create a trust – perhaps effective July 1, 2007 – if the agency has not already done so. As Mr. Firestone noted, the advantage is a higher rate of investment return, on an actual and actuarial basis, and thus a lower annual required contribution in FY08.**

This seems to be the area where the most progress has been made since November. All of the agencies seem headed toward having trust funds in place effective July 1, 2007. From what I have heard they have had a considerable amount of discussion about many of the legal aspects of the trust and are further along than most other counties.

The March 5<sup>th</sup> memo from the Work Group summarizes where they are in developing the trusts. It was noted in that memo that the College has recently expressed an interest in participating in the County's trust for investment purposes only. We think this would be a good idea if it can be done since it would result in some expense savings.

At this point we have only seen a draft of the trust document for the County. We provided some specific comments to the Work Group on this document, none of which were major.

We understand that the current plan is for the County's trust to accept only employer contributions. We agree with this limitation.

4. **Assess the full range of options for limiting liability, including collective bargaining implications that may vary by agency.**

We read the description of "Plan Design Change Considerations" in Attachment A to the March 5<sup>th</sup> Memorandum. While some of the agencies are further along than they were in November, no benefit changes are imminent.

Based on what I heard at the last Work Group meeting and read in the March 5<sup>th</sup> memo, some of the agencies have looked at changes and discussed them with the unions. One group has put off the negotiations of benefit changes for a year. At least one group of retirees has asked for an increase in the employer's share of OPEB benefit cost.

I would like to suggest that the Council consider making a clear point about the increasing burden of retiree benefits costs which will crowd out other parts of the budget over the next five years and beyond.

The idea would be to provide guidance from the Council related to the period of time that any "increase" in past service liability (associated with a benefit improvement) be amortized over. I would suggest that any benefit improvements in either pension or OPEB benefits be amortized over no more than 15 years. Currently longer amortization periods are used which produces a lower short term cost. Given the five year phase-in of the higher OPEB expense this change would seem reasonable. Other reasons to support a shorter amortization period include the following:

- One group noted their increased focus on "total" compensation. Since the average current County employee is expected to stay with the County for no more than an

additional 15 years, this 15 year amortization period is consistent with this philosophy and avoids future generations of taxpayers continuing to pay even after the employees have left and earned their full benefit.

- Under the existing GASB45 30-year level percentage of pay amortization method, the amortization payment does not even cover the interest on the unfunded liability. Dropping this to 15 years will allow the payment to cover the interest and some of the principal.

I would add some other technical details to the recommendation which are: (1) any benefit reductions would be amortized over the same period of time as the total unfunded liability, and (2) gains and losses would continue to be amortized as they are now.

5. **Use consultant assistance for these tasks that can draw on the growing body of experience from other jurisdictions.**

The March 5<sup>th</sup> memo accurately responds to this topic. I would just note that there seems to be a significant increase in the level of discussion as it relates to the legal issues, particularly related to setting up the trust. Many issues have been thought through since the November meeting.

6. **Provide updates to the Committee at least twice in 2006 – for example, in June and November – and regularly in 2007 until implementation begins on July 1, 2007.**

This goal is being met.

7. **Design and implement a communications plan to keep agencies, employees, and the public informed of developments on this issue.**

The communication issues are partly beyond my area of expertise, but what was contained in Attachment B to the March 5<sup>th</sup> memo and the related discussions seem appropriate. I think that it should be appreciated that there is a need to balance information with raising (or not raising) alarms. I think this is a very difficult balance, and the single point of contact at each agency seems appropriate. At this point I do not know what the right message to employees, retirees, and the public is other than to provide information. Not all counties are delivering the same message.

#### **Putting things in context:**

I have been asked to comment on what others are doing in the areas discussed above. Here is a collection of observations:

Within Maryland, Baltimore County stands out. They have a large GASB45 expense which is measured on a more conservative basis than in Montgomery County and many other jurisdictions. They have said that in FY08 they will fully fund the ARC. The county has told the other agencies to do the same and to adjust benefits to accomplish this. The county is currently

in bargaining to change retiree medical and pension benefits, making a link between the two in the context of total compensation.

Anne Arundel County and Howard County have each finished studies that included dozens of potential plan changes. These studies covered County Government, Schools and other agencies. Nothing has yet been decided that would have a material impact on the current GASB45 expense. My impression is that it will be another year or so before we see changes in these counties or the State.

Many Maryland counties are focused more on potential plan changes than on setting up a trust. Almost all seem committed to prefunding a trust in FY08 except for Anne Arundel, which would prefer not to have a formal trust arrangement.

Smaller Maryland entities and many in Virginia are less focused on benefit adjustments since the relative size of the problem and/or benefits promised are less. We have even seen a few improve benefits when the existing benefits were below those offered by surrounding public employers. Often their intent is to immediately pay the full ARC. Nationally the impact of GASB45 is also uneven. Many jurisdictions only offer retirees access to the medical plans, based on a blended cost factoring in the active claims experience.

With some hesitation I will also mention that in Travis County, Texas the county auditor is trying to resist the application of the GASB45 rules and is proposing a state law to remove OPEB benefits from the GAAP standard. However, since GASB is a national standard (that lenders will want followed) and not a state standard, this might have limited success. Most of the arguments are not new, but (1) people certainly understand them better now that the implementation date is here, and (2) it does show a high level of concern about the impact of the change. I do not think that this will change anything, but it is certainly worth watching.

The press and federal government often do not distinguish between unfunded pension obligations and unfunded retiree medical obligations. Likewise there is often no distinguishing by the press between promises made to retirees in the private sector and those in the public sector (see attached letter from the National Association of State Retirement Administrators). How much separation there should be is a matter of debate, but I believe there are legitimate reasons for differences (pensions vs. OPEB and public vs. private). In any case, this has led to a growing questioning of the benefits for public sector employees, but I still see improvements being made to public safety benefits.

Thoughts on the amortization period:

- In the private sector, pension plans were allowed to fund benefit improvements over 30 years. In 2008 the new rule is 7 years for "single employer" plans and 15 years for "multiemployer" plans.
- For GASB45 almost everyone is using the maximum 30-year amortization period, which I assume is because this is a major accounting change and not a new benefit.



- In a recent bargaining process in California, the city's actuary pushed very hard for a shorter amortization period. This is happening elsewhere as well.

**Background:**

The rest of this memo contains some of the background material that was contained in our November memo and an update on the State's GASB45 results.

There is a new accounting standard (GASB 45) for employer provided retiree health and life insurance benefits. This standard will apply for the first time in FY2008. The standard includes a change from determining plan expense on a "pay-as-you-go" cash basis to an accrual standard. Under an accrual standard there is not only an expense for current retirees but also for employees who may one day be entitled to a benefit. The exact amount of the higher expense will depend on whether or not this extra expense is funded during an employee's career. Whether or not additional cash payments are made by the County, the increase in the expense from an accounting perspective is very large (e.g., \$159 million in FY08 for County tax-supported agencies).

Other large counties in Maryland also have material increases in their expenses for FY08. The State of Maryland provided a new estimate of an increase of \$470 million in its annual expense for State employees if they decide to fully fund the expense (\$810 million if they continue to just make pay-as-you-go payments). Public employees in Maryland generally have better retiree medical benefits than employees in other states outside of the northeastern part of the country. In Virginia, some of the counties in Northern Virginia have benefits comparable to those offered in Montgomery County, but as you move away from the DC area the expenses may be only 20% of what they are in Maryland on a per-capita basis. In some states many jurisdictions offer no retiree health or life insurance benefits.

As noted above, the State of Maryland recently revised their GASB45 expense calculations and greatly reduced the expected cost. We have been asked by other counties to see if whatever changed (lowered) the State's cost would also apply to them. The answer is usually no. The biggest change was that the new State valuation lowered the initial assumed increase in health care cost from 14%/year to 11%/year. There was also a change in the percentage of employees electing to be covered by this benefit. The new State assumptions look much like the assumptions currently used by Montgomery County agencies.



NATIONAL ASSOCIATION OF STATE RETIREMENT ADMINISTRATORS  
NATIONAL COUNCIL ON TEACHER RETIREMENT

January 3, 2007

Editor  
*The New York Times*  
229 W 43rd Street  
New York, NY 10036

To the Editor:

The latest in a series of articles ("Estimates for Pensions Tighten," 12/29/06) continues a pattern that reflects a troubling misunderstanding of public pensions. Select quotes from individuals lacking public sector expertise and a focus on only a few pension funds paints an incomplete and misleading picture.

A more complete depiction would note that state and local government pension plans on the whole continue to meet the test of accounting and fiscal responsibility. Collectively, these systems are financially sound and have pre-funded nearly 90 percent of their future liabilities rather than leaving the costs to future generations.

Although the article discusses the Governmental Accounting Standards Board, it ignores GASB's recent paper, "Why Government Accounting and Financial Reporting Is – And Should Be – Different." This paper indicates that the differences between public and private sector accounting for pension plans results from a different approach for governmental accounting standards that "explicitly harmonize accounting with the actuarial funding characteristics of the plan."

The article also implies that whatever applies to the private sector should also apply to the public sector. Nothing could be further from the truth. Federal law prescribes the method corporations must use to calculate their pension liabilities, a method that is conservative in the extreme designed to calculate insurance premiums and address corporate risks such as bankruptcy, mergers, or acquisitions – contingencies generally not applicable to cities and states.

Public pensions, on average, assume an investment return of less than eight percent. Actual public pension investment returns over the past 10- and 20-year periods have *exceeded* that benchmark. If, as the article suggests, public pensions lowered their investment return assumptions to the discount rate used by corporations, there would be a mismatch between pension assets and liabilities that would unnecessarily send taxpayer costs spiraling upward.

State and local governments use investment earnings to appropriately defray costs over the career of their employees, which *lowers* overall retirement costs. For example, since 1982 nearly two-thirds of all public pension revenue has come from investment returns. Taxpayers pay less than one-fourth of the cost of public pensions. The balance comes from employee contributions, which typically are not required in the private sector.

Public retirement funds provide a regular stream of retirement income for nearly seven million Americans. In doing so, these systems contribute to the economy and retirement security of a large segment of the nation's aging population. With nearly \$3 trillion in assets, these funds will continue to do so unless they are undermined by policymakers who rely on incomplete and misleading information.

**M. Steve Yoakum**  
President, National Association of State Retirement Administrators

**Meredith Williams**  
President, National Council on Teacher Retirement

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**Other Post Employment Benefits:** The Governmental Accounting Standards Board (GASB) has issued Statement 45, Accounting and Financial Reporting by Employers for Post-employment Benefits Other than Pensions, which addresses how state and local governments should account for and report their costs and obligations related to Other Post Employment Benefits (OPEB). County agencies are required to disclose their OPEB liabilities in their financial statements, starting with the fiscal year beginning July 1, 2007 (FY08).

In November 2006, the County obtained actuarial valuation information addressing the extent of the County's liability to its retirees for other post employment benefits as of July 1, 2006. Based on the assumptions and qualifications stated therein, the OPEB report concluded that, assuming full pre-funding, the FY08 annual required contribution (ARC) for the County and its tax supported agencies is \$240.0 million, and the related actuarial accrued liability (AAL) is \$2.6 billion. The County has determined that a five year phase in of the difference between the current pay-as-you-go amount to the ARC would be a responsible approach to pre-funding, and believes that such an approach is acceptable to the rating agencies, who will be evaluating the County's response to the GASB disclosure requirements, and its approach to its obligations to current and future retirees for health and other non-pension benefits.

The County is committed to the responsible fiscal management of the County's OPEB obligations and intends to establish a trust on or before July 1, 2007 for such purposes. It is the County's intent to ramp up to full funding of the ARC over a five-year period beginning with FY08. This approach allows the County to use a discount rate higher than its operating investment rate for accounting and budget-

ing purposes, which will result in lower costs and liabilities than if the County did not have a trust in place.

Proposed FY08 OPEB Trust Contributions	
	FY08
<b>Montgomery County Government (MCG)</b>	
<u>General Fund:</u>	
Other Post-Employment Benefits NDA	12,067,320
<u>Proprietary Funds:</u>	
Bethesda Parking District	28,540
Wheaton Parking District	4,280
Silver Spring Parking District	22,830
Solid Waste Collection	12,840
Solid Waste Disposal	102,750
Liquor Control	445,260
Permitting Services	305,400
Community Use of Public Facilities	38,530
Motor Pool	238,320
Risk Management	17,120
Central Duplicating	42,810
<u>Participating Agency Contributions:</u>	
Housing Opportunities Commission	524,000
Revenue Authority	68,000
Strathmore Hall	50,000
Montgomery County Television	35,000
Washington Suburban Transit Commission	5,000
State Agencies	12,000
<b>Total MCG Trust Contributions</b>	<b>14,020,000</b>
<b>Montgomery County Public Schools Trust Fund</b>	<b>16,060,000</b>
<b>Montgomery College Trust Fund</b>	<b>606,400</b>
<b>Park and Planning Commission Trust Fund</b>	<b>1,210,500</b>
<b>Total Contributions/Assets Held in Trust</b>	<b>\$31,896,900</b>

**What are the choices for and legal questions related to funding OPEB?**

1. GASB 45 does not require or create a legal obligation for pre-funding. Indications are that, if OPEB are not funded on an actuarial basis, bond ratings may be affected. The County may continue to pay for OPEB on a Pay-Go basis, if it so desires.
2. OPEB Bonds are a pre-funding option.
  - Bond obligations would have to be within debt limitations of Article 25A, § 5(P) of the Maryland Code, Section 719 of the County Charter, and § 4-10-101 of the County Code, or would require modification of these limitations.
  - Does the pre-funding of OPEB make OPEB bonds “pension liability funding bonds” within Article 31, § 32 of the Maryland Code? (This applies to bonds funding a pension or retirement plan under which the County is obligated to pay retirement, disability, death, or other benefits.)
3. GASB 45 requires that any trust set up to fund OPEB obligations be irrevocable, be dedicated to providing benefits under the plan, and be protected from the creditors of the employer and plan administrator (like a pension trust).
  - Does funding in an irrevocable trust that is like a pension fund create a contractual or other property right to receive the benefits?
  - Changes to State law (Article 95, § 22F of the Maryland Code) defining “public funds”, setting fiduciary standards for their investment, and limiting investment options may be needed to exclude funds for OPEB. This would allow broader investment options for a greater return (as with pension funds).
  - The State could legislatively create a local government investment trust specifically for OPEB.
4. Three trust funding vehicles have been identified to the County thus far.

(Please note that the County’s Office of Law does not have expertise needed to identify all available investment vehicles or their attributes and consequences. This discussion of funding options is based on information that has been provided to the Working Committee by third parties. It is intended as an overview only. When and if the decision is made to use a trust as an investment tool, the Office of Law recommends obtaining the advice of experts in this area.)

- Section 401(h) Account
  - This has been described as a separate account within the pension account that is tracked separately. The assets may be combined with pension assets for investment purposes. It can be set up on an individual basis (defined contribution for each employee) or a pooled basis (defined benefit for each employee).

- The GASB 45 Annual Required Contribution may be greater than the annual contribution limit for this type of account under IRS law.
  - Employee contributions are permitted on a pre-tax basis.
- Voluntary Employees' Beneficiary Association ("VEBA") (Internal Revenue Code § 501(c)(9))
  - The trust is a separate entity from the pension plan, with its own plan and trust fund.
  - No limit to the amount of annual contributions.
  - Employee contributions are allowed only on an after-tax basis.
- Section 115 Trust
  - This is a trust established to provide an "essential governmental function."
  - No limit to the amount of annual contributions.
  - Employee contributions are allowed only on an after-tax basis.
- There are no restrictions on disbursements from any of the three types of trusts. A combination of trusts could be used to obtain tax benefits for participants and avoid the limitation of a Section 401(h) trust.

### Defined Benefit Plans

#### *What is it?*

County law provides that, at the time of retirement, retirees may participate in the County's health care plan. At the current time, the County offers a defined benefit plan. The County contracts with plan providers for specific health care plans (currently, HMO, POS, and Triple Choice – combination POS and PPN). The plan is based on the defined benefits that are offered to employees. The County and the participants share in the costs of the plan based on percentages of cost. The County agrees to pay its percentage share, regardless of the cost of the plan.

#### *What factors may affect the amount of the County's OPEB liability?*

##### **Cost Share**

Obviously, if the County contributes less toward the cost of the health plan, the County's liability decreases. The percentages paid by the County and the participants could be adjusted based on the years of service and the employee group applicable to each participant in order to decrease the share paid by the County.

##### **Plan Design**

Over the years, the County has studied and adjusted the design of the health care plans offered in response to the rising cost of health care. There are countless combinations of plan attributes that can be changed and combined to affect the ultimate cost of the health care, including the types of plans offered, co-pays, out-of-pocket maximums, and limits on certain types of service. Some of the traditional approaches to reducing costs by changing plan design include increasing co-pays, increasing the employee portion of co-insurance levels and increasing deductibles and out of pocket maximums. The impact of increasing co-pays varies because the basic premise of this philosophy is to illustrate the differences in the costs associated with options in the plan provisions. For example, the average cost of a primary care visit and a specialist visit may have a differential in cost which can be addressed by setting appropriate split co-pays (co-pay for primary care physician visits, separate co-pay for specialist visits). Increasing co-insurance levels has a direct financial impact because this philosophy would facilitate the employee paying a higher percentage of the costs of certain services (ie employee pays 10% of inpatient visit instead of paying 0%). Increasing deductibles/out of pocket maximums means the employee would pay slightly more prior to accessing the certain levels of the benefit offering.

Plan offerings are part of the plan design. The County continues to evaluate the number of plans offered and the types of plans offered. These evaluations include physician network access, discounts and provider reimbursements. In addition, the County benchmarks these offerings against other public jurisdictions also taking into account retention and a shrinking workforce for recruiters.

Consumerism, disease management and wellness initiatives are examples of other approaches, which are being incorporated and evaluated in the market place. Health enhancements incorporate behavioral change programs with the leadership of case managers and emphasis is

placed on “preventive” care to alleviate more serious outcomes. These approaches encourage the employee to become a partner with the County with regards to health care. These philosophies increase the employee awareness of the total cost of health care and invite the employee to become better stewards of the monies spent and encourage them to become actively involved in maintaining a healthy lifestyle and making informed decisions to assist the County in reducing health care costs.

It is the consensus of the Task Force, in consultation with the actuaries, that it will be very difficult in today’s health care environment to decrease the overall cost of health care in this manner by any more than 5%. Therefore, such a change would reduce the ARC by about \$6 million (assuming a discount rate of 8% and a level percent of pay amortization). Alternatively, offering a single low cost HMO may result in more savings.

### **Eligibility Requirements**

Another option may be to limit liability by limiting the persons eligible to receive the benefit. This may include only providing post-employment health benefits to employees who attain a certain level of County service, to employees who retire directly from County service, to retirees who attain a certain minimum and/or maximum age, to retirees only and not to their dependents, or to retirees and dependents but without survivor benefits for dependents.

Changes to such eligibility requirements could be based on the employee group applicable to each employee. For instance, the County has already instituted a new structure for eligibility for retirement benefits that applies to employees hired on or after January 1, 2006. This change was discussed on page 11 of this report.

### Examples

The factors just identified can be combined and adjusted in a myriad of combinations and permutations. The following pages represent a suite of options to reduce the liability. It is impossible to present all of the possible combinations of factors and related changes. The evaluation and final determination of how to adjust and combine these factors, if at all, will be decided by the next Administration.

The reductions shown for any particular option cannot be added to the reductions associated with another option due to the possibility of duplication. Four specific combinations of options have been calculated whereby the actuaries have adjusted for any such duplication.

Pages 29 and 30 present the reductions in the Annual Required Contribution associated with each option. Pages 31 and 32 represent the reductions in the Normal Cost associated with the same suite of options. These four pages represent a scenario whereby an 8% discount rate is assumed. The scenarios whereby 6% and 4% discount rates are assumed are included in appendix C. While most of the options are self-explanatory, a few require additional explanation.

*Hard and variable caps* are based on an established published base rate upon which the cost share percentage is applied. While the published rate increases each year due to medical cost inflation, claims experience, plan design changes, etc., the base upon which the county cost share percentage is applied only goes up by the cap percentage. So, assuming the published rate base is \$100 and an 80-20 cost share applies, the employer pays \$80 and the employee pays \$20. Using a hard cap of 5%, if in the following year the published rate goes up 10% to \$110, the employer cost share percentage of 80% would apply to the base of \$105 (base rate plus 5%) yielding an employer contribution of \$84 and an employee share of \$26. The capped base is cumulative, so in year 3, the base rate would increase from \$105 to \$110.25. These options effectively shift all of the market risk onto the employee. If this type of option is chosen, a number of design details (e.g., the published rate used as the base, catch-up provisions in years where rates go up by less than the cap percentage, etc.) would need to be defined and might affect the savings shown. The option shown on the following tables assume the current published rate is used as the base rate.

The *minimum age options* assume that if an employee retires prior to reaching this age, they are ineligible to participate in the County's health plans at any point in time. The options which defer coverage until a certain age provide retirees with access to future coverage once they reach the specified minimum age.

It is also important to note that the reductions shown for each option or specific combination do not take into consideration potential behavioral changes which could impact the actual resultant reduction in cost. For instance, the option whereby a graduated scale is used would lessen the value of the benefit for those with fewer years of service. Therefore, the number of such eventual retirees that actually choose to participate in the plan may drop. This would increase the amount of actual reductions in cost. Another example would be in the options involving minimum years of service or minimum age. Given such a change, employees may remain employed longer than they otherwise would in order to meet the new threshold. This would decrease the amount of actual reductions in cost. When, and if, a specific option is chosen for FY2008, the actuaries will need to analyze these potential behavioral changes and incorporate them into the final valuation for FY2008.



**Reductions in Annual Required Contribution (ARC)  
at 8% Discount Rate and Level Percent of Pay Amortization**  
(numbers expressed in millions)

Employee Group		County Pension Plans				
Factor	Option	Employee	Police	Fire	Jail/Sheriff	Total
Baseline Cost (12.5% health care trend in 2006, end of year)		25.2	16.0	15.3	6.2	62.7
<b>Current Retirees - under 65 and 65+</b>						
Cost Share	Access only (100% share, implicit subsidy only)	-4.1	-3.4	-2.1	-0.7	-10.3
	Graduated Scale (e.g., 2.5% year, max at 75%)	info	info	info	info	0.0
	Hard Cap of 4%	-1.8	-1.4	-0.9	-0.3	-4.4
	Variable Cap based on CPI (3.5%)	-2.0	-1.6	-1.0	-0.3	-4.9
	Eliminate Implicit Subsidy	-1.8	-1.5	-0.9	-0.3	-4.5
	70%-30% Employer-Employee Share	-0.5	-0.4	-0.3	-0.1	-1.3
	60%-40% Employer-Employee Share	-1.0	-0.8	-0.5	-0.2	-2.5
	50%-50% Employer-Employee Share	-1.5	-1.2	-0.7	-0.2	-3.6
<b>Term / Vested</b>						
Cost Share	Access only (100% share, implicit subsidy only)	-0.3	N/A	N/A	0.0	-0.3
	Graduated Scale (e.g., 2.5% year, max at 75%)	info	N/A	N/A	info	0.0
Eligibility	Eliminate	-0.3	N/A	N/A	0.0	-0.3
	Retiree Only (no spouse or dependents)	info	N/A	N/A	info	0.0
<b>Current Employees</b>						
Cost Share	Access only (100% share, implicit subsidy only)	-14.0	-7.4	-8.2	-3.6	-33.2
	Graduated Scale (e.g., 2.5% year, max at 75%)	-6.0	-3.4	-4.1	-0.9	-14.4
	Hard Cap of 4%	-7.0	-3.9	-4.2	-1.8	-16.9
	Variable Cap based on CPI (3.5%)	-7.8	-4.4	-4.7	-2.0	-18.9
Eligibility	Eliminate	-19.1	-11.2	-12.2	-5.2	-47.7
	Eliminate Term Vesting	-0.3	0.0	0.0	-0.1	-0.4
	End Drug Benefits at Age 65	-6.8	-2.0	-2.3	-1.2	-12.3
	End All Benefits at Age 65	-12.5	-3.9	-4.5	-2.2	-23.1
	Retiree & Spouse Only (no dependents)	-1.1	-1.1	-1.1	-0.4	-3.7
	Retiree Only (no spouse or dependents)	-8.9	-5.9	-6.4	-2.4	-23.6
	Minimum of 10 Yrs of Service	-2.7	-0.2	-0.4	-1.2	-4.5
	Minimum of 15 Yrs of Service	-4.4	-0.8	-0.9	-2.4	-8.5
	Minimum of 20 Yrs of Service	-6.5	-2.0	-1.8	-3.3	-13.6
	Minimum Age of 50 years old	-0.6	-4.6	-3.9	-0.5	-9.6
	Minimum Age of 55 years old	-4.3	-9.9	-9.7	-3.5	-27.4
	Minimum Age of 60 years old	-6.4	-11.0	-12.1	-4.3	-33.8
	Minimum Age of 65 years old	-15.7	-11.1	-12.2	-5.2	-44.2
	Defer Coverage until Age of 55 years old	-0.6	-2.4	-2.2	-0.6	-5.8
	Defer Coverage until Age of 60 years old	-2.0	-4.4	-4.4	-1.4	-12.2
	Decrement of 5% per year if retiree participates at an age younger than age 65 (modeled after pension plan approach)	-1.5	-2.4	-2.4	-0.8	-7.1
Combo 1	Min. of 15 Yrs of Service & Graduated Scale	-10.4	-4.1	-4.9	-3.2	-22.6
Combo 2	Min. of 15 Yrs of Service, Graduated Scale & Variable Cap (3.5%)	-12.6	-5.9	-6.6	-3.7	-28.8
Combo 3	Min. of 15 Yrs of Service, Graduated Scale, Variable Cap (3.5%), and Min. Age of 55 yrs	-14.4	-10.6	-11.1	-4.8	-40.9
Combo 4	Min. of 15 Yrs of Service, Graduated Scale and Min. Age of 55 yrs	-12.6	-10.5	-10.8	-4.7	-38.6
<b>All Employee Groups</b>						
Plan Design	Changes to save 5%	-1.3	-0.8	-0.8	-0.3	-3.1

**Reductions in Annual Required Contribution (ARC)  
at 8% Discount Rate and Level Percent of Pay Amortization**  
(numbers expressed in millions)

Employee Group		County	Board of	Community	Public	Grand
Factor	Option	Total	Education	College	Libraries	Total
Baseline Cost (12.5% health care trend in 2006, end of year)		62.7	48.1	4.2	2.6	117.6
<b>Current Retirees – under 65 and 65+</b>						
Cost Share	Access only (100% share, implicit subsidy only)	-10.3	-18.0	-0.4	-0.4	-29.1
	Graduated Scale (e.g., 2.5% year, max at 75%)	0.0	info	info	info	0.0
	Hard Cap of 4%	-4.4	-6.0	-0.1	-0.2	-10.7
	Variable Cap based on CPI (3.5%)	-4.9	-6.6	-0.1	-0.2	-11.8
	Eliminate Implicit Subsidy	-4.5	0.0	-0.1	-0.1	-4.7
	70%-30% Employer-Employee Share	-1.3	-2.6	N/A	0.0	-3.9
	60%-40% Employer-Employee Share	-2.5	-5.3	N/A	-0.1	-7.9
	50%-50% Employer-Employee Share	-3.6	-7.9	N/A	-0.1	-11.6
<b>Term / Vested</b>						
Cost Share	Access only (100% share, implicit subsidy only)	-0.3	N/A	N/A	N/A	-0.3
	Graduated Scale (e.g., 2.5% year, max at 75%)	0.0	N/A	N/A	N/A	0.0
Eligibility	Eliminate	-0.3	N/A	N/A	N/A	-0.3
	Retiree Only (no spouse or dependents)	0.0	N/A	N/A	N/A	0.0
<b>Current Employees</b>						
Cost Share	Access only (100% share, implicit subsidy only)	-33.2	-30.1	-2.6	-1.6	-67.5
	Graduated Scale (e.g., 2.5% year, max at 75%)	-14.4	-4.2	N/A	-0.6	-19.2
	Hard Cap of 4%	-16.9	-14.1	-0.9	-0.7	-32.6
	Variable Cap based on CPI (3.5%)	-18.9	-15.8	-1.1	-0.8	-36.6
Eligibility	Eliminate	-47.7	-30.1	-3.7	-2.0	-83.5
	Eliminate Term Vesting	-0.4	N/A	N/A	0.0	-0.4
	End Drug Benefits at Age 65	-12.3	-13.0	-1.1	-0.8	-27.2
	End All Benefits at Age 65	-23.1	-20.6	-2.7	-1.4	-47.8
	Retiree & Spouse Only (no dependents)	-3.7	N/A	-0.1	0.0	-3.8
	Retiree Only (no spouse or dependents)	-23.6	-12.1	-1.4	-0.7	-37.8
	Minimum of 10 Yrs of Service	-4.5	N/A	N/A	-0.3	-4.8
	Minimum of 15 Yrs of Service	-8.5	N/A	-0.2	-0.6	-9.3
	Minimum of 20 Yrs of Service	-13.6	-4.8	-0.8	-0.9	-20.1
	Minimum Age of 50 years old	-9.6	N/A	0.0	0.0	-9.6
	Minimum Age of 55 years old	-27.4	N/A	0.0	-0.2	-27.6
	Minimum Age of 60 years old	-33.8	-6.2	-1.1	-0.4	-41.5
	Minimum Age of 65 years old	-44.2	-15.8	-2.5	-1.6	-64.1
	Defer Coverage until Age of 55 years old	-5.8	N/A	0.0	0.0	-5.8
	Defer Coverage until Age of 60 years old	-12.2	N/A	-0.2	-0.1	-12.5
	Decrement of 5% per year if retiree participates at an age younger than age 65 (modeled after pension plan approach)	-7.1	-4.6	-0.1	-0.1	-11.9
Combo 1	Min. of 15 Yrs of Service & Graduated Scale	-22.6	-4.2	-0.2	-1.2	-28.2
Combo 2	Min. of 15 Yrs of Service, Graduated Scale & Variable Cap (3.5%)	-28.8	-17.7	-1.3	-1.4	-49.2
Combo 3	Min. of 15 Yrs of Service, Graduated Scale, Variable Cap (3.5%), and Min. Age of 55 yrs	-40.9	-17.7	-1.3	-1.5	-61.4
Combo 4	Min. of 15 Yrs of Service, Graduated Scale and Min. Age of 55 yrs	-38.6	-4.2	-0.2	-1.3	-44.3
<b>All Employee Groups</b>						
Plan Design	Changes to save 5%	-3.1	-2.4	-0.2	-0.1	-5.9

**Reductions in Normal Cost**

**at 8% Discount Rate**

(numbers expressed in millions)

Employee Group		County Pension Plans				
Factor	Option	Employee	Police	Fire	Deo/Sheriff	Total
Baseline Cost (12.5% health care trend in 2006, end of year)		9.8	5.2	5.1	3.0	23.1
<b>Current Retirees - under 65 and 65+</b>						
Cost Share	Access only (100% share, implicit subsidy only)	N/A	N/A	N/A	N/A	N/A
	Graduated Scale (e.g., 2.5% year, max at 75%)	N/A	N/A	N/A	N/A	N/A
	Hard Cap of 4%	N/A	N/A	N/A	N/A	N/A
	Variable Cap based on CPI (3.5%)	N/A	N/A	N/A	N/A	N/A
	Eliminate Implicit Subsidy	N/A	N/A	N/A	N/A	N/A
	70%-30% Employer-Employee Share	N/A	N/A	N/A	N/A	N/A
	60%-40% Employer-Employee Share	N/A	N/A	N/A	N/A	N/A
	50%-50% Employer-Employee Share	N/A	N/A	N/A	N/A	N/A
<b>Term / Vested</b>						
Cost Share	Access only (100% share, implicit subsidy only)	N/A	N/A	N/A	N/A	N/A
	Graduated Scale (e.g., 2.5% year, max at 75%)	N/A	N/A	N/A	N/A	N/A
Eligibility	Eliminate	N/A	N/A	N/A	N/A	N/A
	Retiree Only (no spouse or dependents)	N/A	N/A	N/A	N/A	N/A
<b>Current Employees</b>						
Cost Share	Access only (100% share, implicit subsidy only)	-7.2	-3.4	-3.4	-2.0	-16.0
	Graduated Scale (e.g., 2.5% year, max at 75%)	-2.6	-1.5	-1.5	-0.5	-6.1
	Hard Cap of 4%	-3.6	-1.9	-1.8	-1.0	-8.3
	Variable Cap based on CPI (3.5%)	-4.0	-2.1	-2.1	-1.2	-9.4
Eligibility	Eliminate	-9.8	-5.2	-5.1	-3.0	-23.1
	Eliminate Term Vesting	-0.2	0.0	0.0	-0.1	-0.3
	End Drug Benefits at Age 65	-3.6	-0.9	-0.9	-0.7	-6.1
	End All Benefits at Age 65	-6.6	-1.7	-1.7	-1.2	-11.2
	Retiree & Spouse Only (no dependents)	-0.5	-0.5	-0.5	-0.2	-1.7
	Retiree Only (no spouse or dependents)	-4.5	-2.7	-2.5	-1.4	-11.1
	Minimum of 10 Yrs of Service	-2.0	-0.1	-0.3	-0.8	-3.2
	Minimum of 15 Yrs of Service	-3.2	-0.4	-0.6	-1.5	-5.7
	Minimum of 20 Yrs of Service	-4.4	-1.1	-1.1	-2.0	-8.6
	Minimum Age of 50 years old	-0.3	-2.3	-1.9	-0.3	-4.8
	Minimum Age of 55 years old	-1.7	-4.8	-4.2	-2.0	-12.7
	Minimum Age of 60 years old	-2.7	-5.2	-5.1	-2.5	-15.5
	Minimum Age of 65 years old	-7.9	-5.2	-5.1	-3.0	-21.2
	Defer Coverage until Age of 55 years old	-0.3	-1.2	-1.0	-0.4	-2.9
	Defer Coverage until Age of 60 years old	-0.8	-2.1	-2.0	-0.8	-5.7
	Decrement of 5% per year if retiree participates at an age younger than age 65 (modeled after pension plan approach)	-0.7	-1.1	-1.1	-0.5	-3.4
Combo 1	Min. of 15 Yrs of Service & Graduated Scale	-5.8	-1.9	-2.0	-1.9	-11.6
Combo 2	Min. of 15 Yrs of Service, Graduated Scale & Variable Cap (3.5%)	-6.8	-2.7	-2.8	-2.2	-14.5
Combo 3	Min. of 15 Yrs of Service, Graduated Scale, Variable Cap (3.5%), and Min. Age of 55 yrs	-7.5	-5.0	-4.7	-2.8	-20.0
Combo 4	Min. of 15 Yrs of Service, Graduated Scale and Min. Age of 55 yrs	-6.6	-4.9	-4.6	-2.7	-18.8
<b>All Employee Groups</b>						
Plan Design	Changes to save 5%	-0.5	-0.3	-0.3	-0.2	-1.2

**Reductions in Normal Cost  
at 8% Discount Rate**  
(numbers expressed in millions)

Employee Group		College Univ.	Board of Education	Community College	Public Libraries	Grand Total
Factor	Option					
Baseline Cost (12.5% health care trend in 2006, end of year)		23.1	9.8	1.7	1.1	35.7
<b>Current Retirees – under 65 and 65+</b>						
Cost Share	Access only (100% share, implicit subsidy only)	N/A	N/A	N/A	N/A	N/A
	Graduated Scale (e.g., 2.5% year, max at 75%)	N/A	N/A	N/A	N/A	N/A
	Hard Cap of 4%	N/A	N/A	N/A	N/A	N/A
	Variable Cap based on CPI (3.5%)	N/A	N/A	N/A	N/A	N/A
	Eliminate Implicit Subsidy	N/A	N/A	N/A	N/A	N/A
	70%-30% Employer-Employee Share	N/A	N/A	N/A	N/A	N/A
	60%-40% Employer-Employee Share	N/A	N/A	N/A	N/A	N/A
	50%-50% Employer-Employee Share	N/A	N/A	N/A	N/A	N/A
<b>Term / Vested</b>						
Cost Share	Access only (100% share, implicit subsidy only)	N/A	N/A	N/A	N/A	N/A
	Graduated Scale (e.g., 2.5% year, max at 75%)	N/A	N/A	N/A	N/A	N/A
Eligibility	Eliminate	N/A	N/A	N/A	N/A	N/A
	Retiree Only (no spouse or dependents)	N/A	N/A	N/A	N/A	N/A
<b>Current Employees</b>						
Cost Share	Access only (100% share, implicit subsidy only)	-16.0	-9.8	-1.2	-0.8	-27.8
	Graduated Scale (e.g., 2.5% year, max at 75%)	-6.1	-0.1	N/A	-0.3	-6.5
	Hard Cap of 4%	-8.3	-5.2	-0.4	-0.4	-14.3
	Variable Cap based on CPI (3.5%)	-9.4	-5.9	-0.5	-0.4	-16.2
Eligibility	Eliminate	-23.1	-9.8	-1.7	-1.1	-35.7
	Eliminate Term Vesting	-0.3	N/A	N/A	0.0	-0.3
	End Drug Benefits at Age 65	-6.1	-4.3	-0.5	-0.4	-11.3
	End All Benefits at Age 65	-11.2	-6.7	-1.2	-0.8	-19.9
	Retiree & Spouse Only (no dependents)	-1.7	N/A	-0.1	0.0	-1.8
	Retiree Only (no spouse or dependents)	-11.1	-3.9	-0.6	-0.4	-16.0
	Minimum of 10 Yrs of Service	-3.2	N/A	N/A	-0.2	-3.4
	Minimum of 15 Yrs of Service	-5.7	N/A	-0.1	-0.4	-6.2
	Minimum of 20 Yrs of Service	-8.6	-2.2	-0.5	-0.6	-11.9
	Minimum Age of 50 years old	-4.8	N/A	0.0	0.0	-4.8
	Minimum Age of 55 years old	-12.7	N/A	0.0	-0.1	-12.8
	Minimum Age of 60 years old	-15.5	-1.2	-0.5	-0.2	-17.4
	Minimum Age of 65 years old	-21.2	-4.9	-1.1	-0.8	-28.0
	Defer Coverage until Age of 55 years old	-2.9	N/A	0.0	0.0	-2.9
	Defer Coverage until Age of 60 years old	-5.7	N/A	-0.1	-0.1	-5.9
	Decrement of 5% per year if retiree participates at an age younger than age 65 (modeled after pension plan approach)	-3.4	0.0	-0.1	0.0	-3.5
Combo 1	Min. of 15 Yrs of Service & Graduated Scale	-11.6	-0.1	-0.1	-0.6	-12.4
Combo 2	Min. of 15 Yrs of Service, Graduated Scale & Variable Cap (3.5%)	-14.5	-5.5	-0.6	-0.8	-21.4
Combo 3	Min. of 15 Yrs of Service, Graduated Scale, Variable Cap (3.5%), and Min. Age of 55 yrs	-20.0	-5.5	-0.6	-0.8	-26.9
Combo 4	Min. of 15 Yrs of Service, Graduated Scale and Min. Age of 55 yrs	-18.8	-0.1	-0.1	-0.7	-19.7
<b>All Employee Groups</b>						
Plan Design	Changes to save 5%	-1.2	-0.5	-0.1	-0.1	-1.8

### Defined Contribution Plans

Another change that may be considered is to switch from a defined benefit plan to a defined contribution plan.

#### *What is it?*

Defined contribution plans involve the County providing a fixed dollar amount toward employee and retiree health care. The County's contribution can be defined in respect to an actual amount of dollars or a percentage of pay, with or without maximum dollars.

Defined contribution plans vary widely in design. The responsibility for selection of and payment for health care is generally shifted to the employee. The employer may provide access to the health plans or may require the participant to obtain the insurance in the market place. It should be noted that the administrative and distributive costs of individual policies are much greater than under group policies.

In the simplest form, and the form that has been most commonly used, **employers provide the plans and pay a fixed dollar amount to each participant for the health care.** This may be fixed as the cost of the lowest priced health care option or based on some other basis or calculation. If the employee wants to participate in a plan that offers more benefits, then the employee pays the difference out-of-pocket.

Some of these plans are also called "**cafeteria plans**," in which the employer provides a fixed amount of benefit dollars, and the employee purchases available benefits, like health care, disability insurance, and life insurance, with those dollars. The employee chooses how to spend those dollars and whether to contribute employee dollars based on factors important to the employee. With the cafeteria plan, the employer generally continues to make health care plans available to participants.

Another approach to defined contribution plans is called the **individual market approach**. The employer continues to make a defined contribution toward the benefits. The employee is responsible for obtaining insurance in the market place. It has been noted that, if a large number of employers adopt this approach, health insurance may be more portable. Employees would not have to change their health plan merely because they changed employers. They could continue to use the defined contribution toward the plan they obtained on their own in the market place.

#### *Effects of Use of Defined Contribution Plans on GASB 45 Liability*

Defined contribution plans can be used to fix the County's liability for employee and retiree health care. Many considerations go into calculating and choosing the County's contribution, however, rather than the County's contribution being based on an annual plan cost, the contribution would be under the control of the County. This would lead to more stability and predictability of the County's liability over time. It may also increase the employee and retiree share of the premium for certain plans.

In calculating the County's ARC, the trends in health care costs would not be as relevant to the increased cost to the County over time. The County could calculate its liability based not on

projected health care costs, but on an amount it is willing to contribute toward health care. That amount could increase over time based on projected increases in payroll costs or other price indices, and not necessarily on the rising cost of health care.

### **Account-Based Health Plans**

Another option for funding health benefits for employees and retirees is the implementation of some type of account-based health plan. The County already offers one type of account-based plan, a Flexible Spending Account, to its employees. This allows employees to pay certain health care expenses not covered by insurance with pre-tax dollars deducted from pay and put into an account with an outside administrator. There are IRS limits on the amount that can be placed into the account, and funds that are not used during the plan year are lost by the employee.

There are other accounts that can be used to pay for health care expenses that are used in place of other defined benefit and defined contribution plans. The following summarizes some of the features of two of the available types of plans. It should be noted, however, that more detailed analysis and advice would be required to determine the tax qualifications and implications, as well as the eligibility requirements and all plan features.

**Health Savings Accounts ("HSA")** are tax exempt accounts that are used to pay health care expenses. The HSAs are actually owned by the employee, and, therefore are portable between employers. Funds not used are not lost, but roll over for future use. At this time these accounts are not widely used, but it is anticipated that because of recent IRS rulings these accounts will become more common. To qualify for the tax exempt status, contributions to HSAs must be made while the participant is enrolled in a health plan with a high annual deductible. Deductions can be made at any time, even when the participant is no longer in the high deductible plan. Employers can contribute to the HSA, but the maximum contribution to a plan cannot exceed the plan deductible. Medicare beneficiaries are not permitted to contribute to HSAs, but they can make withdrawals for certain expenses. Individuals older than 55 can make limited "catch-up" contributions.

**Health Reimbursement Arrangements ("HRA")** are employer funded health plans that reimburse employees for qualified medical expenses. A high deductible health plan can also be used, but is not required. If an HRA is offered with plans with high deductibles, it can be used to assist the employee with meeting that deductible. HRAs can also be used to allow employees to purchase benefits, including for long-term care and health care during retirement. HRAs are paper accounts only, and no expense is incurred by an employer until there is a claim. Unused "funds" can be rolled over for use in subsequent plan years. If an employee leaves employment, the employer is not required to make unused amounts available to the employee.

Like defined contribution plans, account-based plans may result in a somewhat more predictable and controllable future liability for the County. These account plans can be used in combination with certain defined benefit and defined contribution plans, again resulting in numerous possible combinations and resulting options.

The purpose for this section of the report is to identify the potential funding gaps, provide some context for the various funding options, and address the implications of doing nothing.

### **Identification of the Funding Gap**

The difference between the total Annual Required Contribution (ARC) and the current “pay-as-you-go” funding for retiree health benefits is the initial funding gap. The chart below shows this calculation in total as well as for the County government itself and the three component units. Similar calculations can be made under the other two discount rate scenarios. The total ARC gap using a 6% discount rate is \$97.7 million, and using a 4% discount rate is \$137.2 million.

<b>Identification of Initial Funding Gap</b> Discount Rate of 8% (dollars expressed as millions)					
	County	Board of Education	Community College	Libraries	Total
<b>Baseline</b>					
Amortized AAL	\$39.7	\$38.3	\$2.5	\$1.5	\$82.0
Normal Cost	\$23.0	\$9.8	\$1.7	\$1.1	\$35.6
<i>Total ARC</i>	\$62.7	\$48.1	\$4.2	\$2.6	\$117.6
Pay-as-you-go	\$15.0	\$25.1	\$1.3	\$0.8	\$42.2
<b>Total ARC Gap</b>	\$47.7	\$23.0	\$2.9	\$1.8	\$75.4
<i>% of whole</i>	63%	31%	4%	2%	100%

This initial funding gap can be broken down into two different components as shown in the chart below. The “Amortized AAL Gap” represents that portion of the funding gap that is due to liabilities incurred over many years in the past. It can be thought of as a “backlog” of sorts. The “Normal Cost” component represents that portion of the funding gap that is attributable to the budget year in question (i.e., FY2008). This should be thought of as a “recurring” cost.

<b>Two Components of Initial Funding Gap</b> (dollars expressed as millions)			
Discount Rate	Amortized AAL	Normal Cost	Total ARC Gap
8%	\$39.8	\$35.6	\$75.4
6%	\$43.3	\$54.4	\$97.7
4%	\$48.2	\$89.0	\$137.2

County financial policy dictates that one-time funds should not be used to fund “recurring costs” such as the Normal Cost gap. However, it may be prudent to apply one-time funds to fund a “backlog” such as the Amortized AAL gap.

If none of the previously presented options to reduce the liability are chosen and the ARC is not otherwise reduced, then the final funding gap would be as shown on the previous page. If the ARC is reduced by some combination of options totaling \$75.4 million, then the final funding gap would be reduced to zero. If the ARC is reduced by some combination of options totaling half of the initial funding gap, then the final funding gap would be \$37.7 million.

Similarly, under the 6% discount rate scenario, the final funding gap would range from \$0 to \$97.7 million, with \$48.9 being the midpoint. And, under the 4% discount rate scenario, the final funding gap would range from \$0 to \$137.2 million, with \$68.6 million being the midpoint.

### **Putting the Final Funding Gap in Context**

If options are sought to fund the final funding gap, they can be broken down into three broad categories: increasing revenues, decreasing expenditures, and other sources. While it's not within the scope of this report to make recommendations as to funding approaches, it is useful to view these possible final funding gaps in the context of specific areas within these three broad categories.

#### **Increasing Revenues**

- A one-cent increase in the property tax yields about \$5 million annually.
- A 25% increase in the income tax from 2.56% to 3.20% would be the maximum allowed under state law and would yield about \$80 million annually. This tax rate is comparable to Howard, Prince George's, and Montgomery Counties.
- A 10% increase in the income tax from 2.56% to 2.82% would yield about \$32 million annually and is comparable to the Baltimore County tax rate.
- A 5% increase in the income tax rate from 2.56% to 2.69% would yield about \$16 million annually.

#### **Decreasing Expenditures**

- One percent of all salaries (including component units, and FICA and pension where applicable) equals about \$7.3 million annually.
- In order to provide a departmental context for any potential changes in expenditure levels, a departmental breakdown of the FY2007 Approved General Fund operating budget is shown in Appendix D. Overall, the total ARC of \$117.6 million is approximately equal to 10% of the General Fund operating budget.



**Accrual Accounting** – A term used to describe the method of recognizing costs when economic events occur regardless of when cash will be needed to satisfy obligations.

**Actuarial Accrued Liability (AAL)** – This is the portion of the Total Present Value of Projected Benefits (TPV) attributable to service provided to date. For example, if an individual is expected to have 25 years of service upon retirement and has 10 years of service at the valuation date, the AAL is 10/25ths of the TPV. For someone that is already retired at the valuation date, the AAL is equal to the TPV.

**Actuarial Present Value of Total Projected Benefits** – This represents the total projected benefits to be paid to employees / retirees discounted back to current dollars.

**Actuarial Valuation Date** – This is the date as of which the actuarial evaluation is performed. The evaluation uses employer data as of this particular date to calculate liabilities, etc.

**Actuarial Value of Assets (AVA)** – The market value of assets that have been set aside exclusively for funding retiree healthcare. For plans that are not funded, the AVA = \$0.

**Amortization Period** – The time period used to amortize the Annual Required Contribution (ARC) related to past service costs.

**Annual Required Contribution (ARC)** – The annual contribution required to conform to GASB 45 standards and avoid a liability from appearing on the balance sheet. The ARC consists of two parts: (1) a payment against the previously unfunded actuarial accrued liability (UAAL) which is equal to the UAAL amortized over a set number of years (maximum allowed is 30 years), plus (2) the Normal Costs.

**Blended Premium** – A healthcare premium that does not take into account the age of the individuals covered, as when a single premium is used for both active and retired employees.

**Governmental Accounting Standards Board (GASB)** – GASB is a nationally established board that sets standards for accounting and reporting for State and local governments and their component units. Governments follow these standards in order to fairly present financial information and to receive an unqualified audit opinion on their annual financial statements.

**Implicit Rate Subsidy** – The de facto subsidy of retirees by permitting them to pay lower than age-adjusted premiums through the use of a single common or blended premium for both retirees and active employees.

**Normal Service Costs** – The portion of the Total Present Value of Projected Benefits (TPV) allocated to the current year (i.e., the amount attributable to services provided to date by current employees). For example, if an individual is expected to have 25 years of service upon retirement, this is 1/25th of the individual's TPV. There is no Normal Service Cost for retirees.

**Other Post Employment Benefits (OPEB)** – This term is used to describe any benefit (separate from a pension plan) offered to employees after employment is severed.

**Past Service Costs** – The portion of the Total Present Value (TPV) that relates to services rendered by employees in past years.

**Pay as you go** – A term to describe the method of recognizing costs as bills are due. This method is based on when cash will be needed to pay the bills. When used in reference to OPEB, this term refers to the actual costs incurred by the government to pay for retiree healthcare in a given fiscal year.

**Total Present Value of Projected Benefits (TPV)** – An amount calculated by actuarial methods to estimate the amount of benefits (in current dollars) both former and current employees will be paid during retirement. The calculation estimates the required future pay outs and then determines what those pay outs are valued in today's dollars. For an individual person, this would be the value of all benefits expected to be paid from the date of retirement until death discounted back to the valuation date.

**Total Projected Benefits** – An amount calculated by actuarial methods to estimate the amount of benefits both former and current employees will be paid during retirement.

**Unfunded Actuarial Accrued Liability (UAAL)** – This represents the amount of the AAL for which funds have not been set aside. It is calculated as the actuarial accrued liability (AAL) minus the actuarial value of assets (AVA). For plans that are not funded, the UAAL is equal to the AAL.

**BULLETIN NO.: 05-04-13**

**SUBJECT: Eligibility for Health Insurance  
As A Retired County Employee**

**December 31, 2006**

**[X] DEPARTMENT HEADS**

**[X] PLEASE POST UNTIL**

**DATE: January 1, 2006**

**[ ] GENERAL DISTRIBUTION  
TO ALL EMPLOYEES**

**[X] PERSONNEL OFFICE**

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This policy supercedes all previous written policy statements and is effective January 1, 2006 unless otherwise indicated.

**Policy:**

**I. Eligibility for Benefits**

- a. Employees of the County government who are participants in the County Pension plan and were hired prior to January 1, 2006, are eligible to participate in the County-sponsored post employment health benefit programs upon their retirement.
- ✓ b. Employees hired or re-hired after January 1, 2006 must retire directly from Anne Arundel County Government and must have a minimum of 15 years of credited pension service as defined by Section 1-205 (a), Article 5 (old Article 7), Anne Arundel County Code to be eligible to participate in the County-sponsored post employment health benefit programs upon retirement.
- c. Dependents of a retiree will be eligible for coverage as long as the retiree is receiving pension payments. Survivors who continue to receive pension payments after the death of the retiree are eligible to continue coverage, but may not add additional dependents unless there was a prior dependent relationship between the original retiree and the covered dependent.
- d. Those employees of the Anne Arundel Economic Development Corporation who are participants in the County Pension Plan and who were hired prior to January 1, 2006 are eligible to participate in County-sponsored post employment health benefit programs upon retirement.




OFFICE OF THE COUNTY EXECUTIVE  
ROCKVILLE, MARYLAND 20850

Isiah Leggett  
County Executive

MEMORANDUM

April 5, 2007

TO: Marilyn Praisner, President  
Montgomery County Council

FROM: Isiah Leggett, County Executive 

SUBJECT: Information Supporting Resolution for Five-Year Phase-In of OPEB Obligation

The purpose of this memorandum is to provide additional information regarding the County's discussions with the rating agencies regarding its outstanding OPEB obligations. As you know, I am strongly committed to the County's existing agreements with the rating agencies and moving forward with funding of the difference between the current pay as you go funding and the ARC over a five-year period beginning in FY08. I believe that this approach is not only an appropriate way to address an obligation of this magnitude, it is what was carefully negotiated with the rating agencies. Funding consistent with the five-year phase-in is included in my Recommended FY08 Operating Budget for Montgomery County Government, Montgomery County Public Schools, Montgomery College, the County portion of M-NCPPC, and WSSC.

As has been documented in various MFP packets over the past several years, the County began its work to prepare for the new accounting rules early, with the release of the first exposure draft of GASB 45 in 2003. At that time, Montgomery County was prompt in obtaining an actuarial valuation of its outstanding OPEB obligation.

That actuarial valuation was performed by Mercer as of July 1, 2003 and presented to the County in November 2003. At that time, Montgomery County's Finance Director began discussions with the rating agencies to ensure an accurate common understanding of the GASB 45 requirement, how it would impact the County's financial statements, and what the impact would be on the County financially if full pre-funding was implemented. Thereafter, the County's OPEB obligation was reflected in its fiscal plans and rating agency presentations, beginning in March 2004. Three consecutive years of fiscal plans – the FY05-10 Fiscal Plan presented in March 2004, the FY06-11 Fiscal Plan presented in April 2005, and the FY07-12 Fiscal Plan presented in April 2006 – were included in the presentation. The OPEB obligation was displayed on the Fiscal Plan as a \$156.3 million expenditure pressure beginning in FY07 on the FY05-10 plan and shifted out to FY08 on the latter two fiscal plans.

While the rating agencies were impressed that the County was presenting its OPEB obligation in this planning document, the discussions focused on how Montgomery County and other affected governments would afford the large amounts often resulting from the actuarial valuations. The County first floated the concept of a multi-year ramping up to the full ARC around the same time that the County received the updated actuarial report. Still concerned

Marilyn Praisner  
April 5, 2007  
Page 2

about the large impact on County finances of full pre-funding, Finance began advocating for a phase-in approach and over the next year obtained assurances of the rating agencies' comfort with that approach. Ensuing conversations focused on the time frame for the phase-in, and I understand that the first time frame discussed was three years. However, additional negotiations focused on a five-year phase-in, and that was the plan finally agreed upon.

I have attached a copy of the Fitch Ratings June 2005 Special Report on the Credit Implications of GASB 45, which notes the assistance of Finance Department staff at Montgomery County and discusses expectations for governments to steadily ramp up annual contributions to actuarially determined levels or taking other actions to address the funding, "much the same way they responded to the adoption of pension system actuarial and accounting standards." This article also notes that "over time, a lack of substantive progress in funding and managing OPEB liabilities or a failure to develop a realistic plan to meet annual OPEB contributions could adversely affect an issuer's credit rating."

In stark contrast to the previously displayed \$156.3 million full pre-funding of the County's OPEB obligation displayed in its last three fiscal plans, the FY08-13 Fiscal Plan reflects a contribution of \$31.9 million in additional funds included in the tax-supported agencies' uses in FY08, ramping up to \$187.7 million in FY12. These amounts reflect the latest actuarial valuations completed for each of the tax-supported agencies in the past year. These five year phase-in amounts were also reviewed by the Council and highlighted by the Council Staff Director in the Council's Overview of Economic Indicators and the FY08-13 Fiscal Plan packet this past December (excerpts attached).

I want to commend the Multi-Agency OPEB Work Group for its good work in this area over the past four years, and its member's efforts to collaboratively update valuations and include amounts consistent with the agreed-upon five-year phase-in approach in the respective agency budgets. With the costs of our promises to retirees in terms of health benefits fully disclosed in our financial statements, and an expectation that these benefits be funded, our challenges in containing the costs of these promises becomes great. At a minimum, we need to continue to commit to the current plan to fund the obligations already in place.

In summary, I strongly caution the Council against moving away from the *commitment already negotiated with the rating agencies and included in its fiscal planning* documents in regards to the County's five-year phase-in of funding for its obligation to its retirees for health and other benefits. We cannot unilaterally change the schedule without potentially negatively affecting the County's rating. At best, we would have to go back and renegotiate the schedule without certainty that it would be accepted.

IL/jeb

Attachments



## County Executive's Recommended FY05-10 Public Services Program Tax Supported Fiscal Plan Summary

( \$ in Millions)															
	App FY04	Estimate FY04	% Chg. FY04-05 Rec/Bud	% Chg. FY04-05 Rec/Est	Rec FY05	% Chg. FY05-06	Projected FY06	% Chg. FY06-07	Projected FY07	% Chg. FY07-08	Projected FY08	% Chg. FY08-09	Projected FY09	% Chg. FY09-10	Projected FY10
<b>Total Resources</b>															
Revenues	2,633.9	2,714.8	7.8%	4.6%	2,840.3	5.6%	3,000.7	8.1%	3,244.7	7.6%	3,488.9	4.6%	3,651.5	3.8%	3,788.9
Beginning Reserves Undesignated	87.1	81.6	40.4%	49.8%	122.3	-35.6%	78.8	10.1%	86.8	16.0%	100.7	14.2%	115.0	8.1%	124.4
Beginning Reserves Designated	0.6	0.6	-100.0%	-100.0%	0.0	0.0%	2.3	54.0%	3.5	37.6%	4.9	27.5%	6.2	21.6%	7.5
Net Transfers In	22.0	23.7	-156.8%	-152.7%	(12.5)	-280.0%	22.5	2.4%	23.0	2.5%	23.6	2.4%	24.2	2.3%	24.7
<b>Total Resources Available</b>	<b>2,743.6</b>	<b>2,820.8</b>	<b>7.5%</b>	<b>4.6%</b>	<b>2,950.0</b>	<b>5.2%</b>	<b>3,104.3</b>	<b>8.2%</b>	<b>3,358.0</b>	<b>7.8%</b>	<b>3,619.1</b>	<b>4.8%</b>	<b>3,796.9</b>	<b>3.8%</b>	<b>3,945.5</b>
<b>Non-Agency Uses of Resources</b>	<b>301.5</b>	<b>381.1</b>	<b>10.9%</b>	<b>-12.3%</b>	<b>334.4</b>	<b>10.4%</b>	<b>369.3</b>	<b>2.1%</b>	<b>377.0</b>	<b>9.4%</b>	<b>412.4</b>	<b>3.1%</b>	<b>425.2</b>	<b>3.9%</b>	<b>441.8</b>
<b>Available to Allocate to Agencies</b>	<b>2,442.1</b>	<b>2,439.7</b>	<b>7.1%</b>	<b>7.2%</b>	<b>2,615.6</b>	<b>4.8%</b>	<b>2,735.0</b>	<b>9.0%</b>	<b>2,981.0</b>	<b>7.6%</b>	<b>3,206.7</b>	<b>5.1%</b>	<b>3,371.7</b>	<b>3.9%</b>	<b>3,503.7</b>
<b>Agency Uses: Recommended</b>															
Montgomery County Public Schools (MCPS)	1,388.9	1,380.2	5.7%	6.4%	1,468.0	7.8%	1,580.0	7.0%	1,689.9	3.6%	1,751.1	0.9%	1,767.3	0.6%	1,778.4
Montgomery College (MC)	145.4	139.0	4.1%	8.9%	151.4	7.3%	162.5	5.2%	170.9	1.6%	173.6	1.6%	176.5	1.6%	179.3
MNCPCC (w/o Debt Service)	70.2	71.2	5.8%	4.4%	74.3	4.7%	77.8	0.1%	77.9	0.0%	77.9	0.0%	77.9	0.2%	78.1
MCG	837.6	849.3	10.1%	8.6%	921.9	5.3%	971.2	3.4%	1,004.4	1.4%	1,018.1	1.1%	1,029.0	0.8%	1,037.0
<b>Total Agency Uses</b>	<b>2,442.1</b>	<b>2,439.7</b>	<b>7.1%</b>	<b>7.2%</b>	<b>2,615.6</b>	<b>6.7%</b>	<b>2,791.5</b>	<b>5.4%</b>	<b>2,943.1</b>	<b>2.6%</b>	<b>3,020.7</b>	<b>1.0%</b>	<b>3,050.7</b>	<b>0.7%</b>	<b>3,072.8</b>
<b>Subtotal Uses (Non-Agency + Agency)</b>	<b>2,743.6</b>	<b>2,820.8</b>	<b>7.5%</b>	<b>4.6%</b>	<b>2,950.0</b>	<b>7.1%</b>	<b>3,160.8</b>	<b>5.0%</b>	<b>3,320.2</b>	<b>3.4%</b>	<b>3,433.1</b>	<b>1.2%</b>	<b>3,475.9</b>	<b>1.1%</b>	<b>3,514.6</b>
<b>Tier 1</b>															
(Gaps)/Available at Major Known Commitments					0.0		(55.5)		37.9		186.0		321.0		430.9
<b>Tier 2</b>															
<b>Other Expenditure Pressures</b>							0.0		13.1		79.7		152.6		223.7
Government Accounting Standards Board Statement Number 33 (GASB 33)							0.0		158.3		160.6		164.9		169.2
(Gaps)/Available with Other Expenditure Pressures and GASB 33							(66.5)		(131.6)		(54.3)		3.4		38.0

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# County Executive's Approved FY06-11 Public Services Program Tax Supported Fiscal Plan Summary

(\$ in Millions)																
A	App FY05 5-22-03	Estimate FY03 3-15-05	% Chg. FY05-06 Revised	% Chg. FY05-06 Needlet	Rec FY06 3-15-05	% Chg. FY06-07	Projected FY07	% Chg. FY07-08	Projected FY08	% Chg. FY08-09	Projected FY09	% Chg. FY09-10	Projected FY10	% Chg. FY10-11	Projected FY11	
Total Resources																
Revenues	2,970.7	2,933.7	8.6%	6.2%	3,116.1	6.6%	3,320.2	7.7%	3,577.4	6.2%	3,798.4	5.4%	4,005.3	5.7%	4,232.4	
Beginning Reserves Undesignated	120.7	134.5	2.5%	-7.8%	124.1	-28.1%	91.7	10.7%	101.6	15.2%	117.1	11.8%	130.7	9.5%	143.1	
Beginning Reserves Designated	0.0	1.0	n/a	-31.8%	1.9	65.3%	3.1	18.4%	3.7	16.5%	4.3	15.0%	5.0	6.8%	5.3	
Net Transfers In (Out)	(11.9)	(12.0)	-313.2%	-310.1%	25.3	-2.6%	26.0	2.6%	26.6	2.5%	27.3	2.5%	28.0	2.6%	28.7	
Total Resources Available	2,979.6	3,057.1	8.6%	6.8%	3,266.4	6.3%	3,441.1	7.8%	3,706.4	6.4%	3,947.1	5.6%	4,169.0	5.8%	4,409.5	
Less Other Uses of Resources (Capital, Debt Service, Reserve)	329.3	400.4	11.6%	-8.0%	368.3	4.9%	386.3	9.5%	423.0	3.8%	439.0	5.4%	462.9	4.6%	484.0	
Available to Allocate to Agencies	2,650.2	2,656.8	9.4%	8.1%	2,898.0	6.4%	3,054.8	7.6%	3,283.3	6.7%	3,508.0	6.6%	3,706.1	6.9%	3,925.6	
Agency Uses																
Montgomery County Public Schools (MCPB)	1,491.7	1,488.4	7.4%	7.6%	1,502.0	2.2%	1,638.6	3.7%	1,697.7	1.0%	1,714.0	0.8%	1,725.1	0.0%	1,726.1	
Montgomery College (MC)	151.5	149.1	8.7%	10.4%	164.6	3.1%	169.7	1.8%	172.4	1.6%	175.2	1.6%	178.1	1.5%	180.8	
MNCPPC (w/o Debt Service)	77.5	77.5	12.2%	12.2%	87.0	4.6%	91.0	0.0%	91.0	0.0%	91.0	0.0%	91.0	0.0%	91.0	
MCG	729.6	941.8	12.4%	10.8%	1,044.8	3.9%	1,085.3	1.8%	1,104.8	1.2%	1,119.0	1.0%	1,126.7	0.9%	1,138.6	
Subtotal Agency Uses	2,650.2	2,666.8	9.4%	8.1%	2,898.0	2.9%	2,962.6	2.8%	3,086.0	1.0%	3,095.1	0.8%	3,122.8	0.4%	3,136.6	
Subtotal Other Uses of Resources (Capital, Debt Service, Reserve)	329.3	400.4	11.6%	-8.0%	368.3	4.9%	386.3	9.5%	423.0	3.8%	439.0	5.4%	462.9	4.6%	484.0	
Total Uses	2,979.6	3,067.1	9.6%	8.6%	3,266.4	3.1%	3,368.9	3.6%	3,489.0	1.4%	3,537.2	1.4%	3,586.7	0.9%	3,619.5	
Tier 1																
(Gaps)/Available at Major Known Commitments		0.0					72.3		220.4		408.9		683.2		790.1	
Tier 2																
Other Expenditure Pressures		0.0					(107.5)		(114.0)		(171.9)		(177.2)		(194.5)	
Government Accounting Standards Board Statement Number 43/48		0.0					0.0		(196.3)		(180.6)		(164.9)		(169.2)	
(Gaps)/Available with Other Expenditure Pressures and GASB 43/48		0.0					(36.2)		(60.0)		77.4		241.2		428.3	

**County Executive's Recommended FY07-12 Public Services Program  
Tax Supported Fiscal Plan Summary**

	App FY06	Estimate FY06 3-15-06	% Chg. FY06-07 Budget	% Chg. FY06-07 Budget	Res FY07 3-15-06	% Chg. FY07-08	Projected FY08	% Chg. FY08-09	Projected FY09	% Chg. FY09-10	Projected FY10	% Chg. FY10-11	Projected FY11	% Chg. FY11-12	Projected FY12
<b>Total Resources</b>															
Revenues	3,040.9	3,104.5	9.5%	4.3%	3,331.7	7.2%	3,570.5	6.5%	3,801.8	5.7%	4,018.9	6.0%	4,280.8	5.9%	4,510.6
Beginning Reserves Undesignated	144.6	221.0	49.3%	10.8%	244.8	-54.5%	110.6	1.1%	111.6	11.1%	124.3	10.9%	137.8	10.9%	152.8
Beginning Reserves Designated	1.9	1.0	49.5%	48.5%	2.8	560.5%	16.7	-78.5%	4.0	16.1%	4.7	7.9%	5.0	6.8%	5.4
Net Transfers In (Out)	25.0	24.3	5.2%	8.0%	25.3	2.6%	27.0	2.7%	27.7	2.7%	28.4	2.7%	29.2	2.7%	30.0
<b>Total Resources Available</b>	<b>3,212.3</b>	<b>3,441.7</b>	<b>12.2%</b>	<b>4.8%</b>	<b>3,603.8</b>	<b>3.1%</b>	<b>3,726.7</b>	<b>5.9%</b>	<b>3,945.3</b>	<b>5.9%</b>	<b>4,176.2</b>	<b>6.1%</b>	<b>4,432.8</b>	<b>6.0%</b>	<b>4,688.7</b>
Less Other Uses of Resources (Capital, Debt Service, Reserve)	335.7	547.3	-17.1%	-17.1%	493.5	-1.9%	445.0	2.2%	454.8	5.3%	478.1	5.3%	504.5	5.2%	530.7
<b>Available to Allocate to Agencies</b>	<b>2,876.6</b>	<b>2,894.4</b>	<b>0.6%</b>	<b>0.6%</b>	<b>3,112.0</b>	<b>4.1%</b>	<b>3,281.8</b>	<b>6.4%</b>	<b>3,490.5</b>	<b>6.3%</b>	<b>3,697.1</b>	<b>6.3%</b>	<b>3,928.3</b>	<b>6.1%</b>	<b>4,158.0</b>
<b>Agency Uses</b>															
Montgomery County Public Schools (MCPS)	1,592.2	1,591.2	7.5%	7.6%	1,711.5	6.7%	1,826.1	6.7%	1,948.2	6.7%	2,078.6	6.7%	2,217.6	6.7%	2,368.0
Montgomery College (MC)	164.4	156.6	6.3%	13.3%	176.7	7.3%	182.7	7.3%	190.7	7.3%	201.7	7.3%	217.6	7.3%	235.1
MNCPCC (two Debt Service)	84.3	84.9	6.6%	6.3%	89.4	4.3%	93.3	4.3%	97.3	4.3%	101.8	4.3%	106.9	4.3%	112.3
MCG	1,035.7	1,059.7	13.1%	10.5%	1,171.4	5.7%	1,237.7	5.7%	1,307.8	5.7%	1,381.8	5.7%	1,460.9	5.7%	1,542.8
<b>Subtotal Agency Uses</b>	<b>2,876.6</b>	<b>2,894.4</b>	<b>0.6%</b>	<b>0.6%</b>	<b>3,112.0</b>	<b>6.3%</b>	<b>3,281.8</b>	<b>6.3%</b>	<b>3,490.5</b>	<b>6.3%</b>	<b>3,697.1</b>	<b>6.3%</b>	<b>3,928.3</b>	<b>6.3%</b>	<b>4,174.1</b>
Subtotal Other Uses of Resources (Capital, Debt Service, Reserve)	335.7	547.3	-17.1%	-17.1%	493.5	-1.9%	445.0	2.2%	454.8	5.3%	478.1	5.3%	504.5	5.2%	530.7
<b>Total Uses</b>	<b>3,212.3</b>	<b>3,441.7</b>	<b>12.2%</b>	<b>4.8%</b>	<b>3,605.5</b>	<b>5.2%</b>	<b>3,726.7</b>	<b>5.9%</b>	<b>3,945.3</b>	<b>6.2%</b>	<b>4,176.2</b>	<b>6.2%</b>	<b>4,432.8</b>	<b>6.2%</b>	<b>4,714.8</b>
<b>(Gap)/Available at a historical rate of growth</b>					<b>0.0</b>		<b>(66.0)</b>		<b>(66.0)</b>		<b>(66.0)</b>		<b>(66.0)</b>		<b>(106.1)</b>
<b>Tier 1</b>															
<b>Tier 2</b>					<b>0.0</b>		<b>(156.3)</b>		<b>(160.8)</b>		<b>(164.9)</b>		<b>(169.2)</b>		<b>(182.2)</b>
<b>Government Accounting Standards Board Statement Number 43/45</b>															

**County Executive's Recommended FY07-12 Public Services Program  
Tax Supported Fiscal Plan Summary Assumptions**

- Item 1:**
- Projected Agency Uses for FY08-12 for all agencies are based on "Average of the Annual Rate of Change in actual budgets for the period FY95 to FY05 and approved budget of FY06".
  - For MCPS, MOE requires the same local contribution per pupil in each year.
  - For MC, MOE is the same local contribution amount as in the previous year.
  - Additional State aid at current formulas, miscellaneous revenues, and additional tuition revenues are assumed as applicable.
  - The Fuel Energy Tax is maintained at the rates approved for the FY08 budget.
  - The labor contracts will expire as follows:
    - MNCPCC's contract with MCGEO expires at the end of FY08.
    - The MCG contracts with the County Fraternal Order of Police (FOP) Lodge 435 and Municipal and County Government Employees Organization (MCGEO) Local 1894 will expire at the end of FY07.
    - It is assumed here that the Board of Education's contracts with the Montgomery County Education Association, Montgomery County Council of Supporting Services Employees, and the Montgomery County Association of Administrative and Supervisory Personnel (MCAASP) will expire at the end of FY07.
    - The County's contract with the International Association of Firefighters (IAFF) Local 1684 expires at the end of FY08.
  - The County's estimate under Council Resolution #15-105 includes a one-time income tax credit offset of \$28,506,457 and a homeowners tax credit of \$4,541,553.
  - For FY08-12, the estimates do not include an income tax credit offset, but assume a homeowner tax credit of \$4,541,553 which is reauthorized every fiscal year.
- Item 2:**
- Tier 2 also includes the estimated cost of compliance with GASB 43/45, pre-funding post-employment group insurance benefits.



## Special Report

## The Not So Golden Years Credit Implications of GASB 45

### Analysts

Joseph D. Mason  
1 703 245-3068  
joseph.mason@fitchratings.com

Amy S. Doppelt  
1 415 732-5612  
amy.doppelt@fitchratings.com

Amy R. Laskey  
1 212 908-0568  
amy.laskey@fitchratings.com

David T. Litvack  
1 212 908-0593  
david.litvack@fitchratings.com

*The authors wish to thank finance department staff at Montgomery County, MD for sharing the results of a preliminary study of the county's OPEB liabilities, which provided valuable context to this report.*

### Related Research

- "Reversal of Fortune: The Rising Cost of Public Sector Pensions and Other Post-Employment Benefits," Sept. 18, 2003
- "Local Governments Pressured by Rising Employee Health Care Costs," Dec. 13, 2004

### ■ Summary

A new public sector accounting standard touches on three hot topics: skyrocketing health care costs, the ongoing national debate over retirement security, and the recent emphasis on greater financial disclosure. Governmental Accounting Standards Board (GASB) Statement No. 45 relates to other post-employment benefits (OPEB) — payments and services provided for retirees other than pensions. OPEB consist mainly of retiree health care benefits. GASB 45 applies the accounting methodology used for pension liabilities (GASB 27) to OPEB and is similar in concept to an accounting standard adopted for the private sector in the mid-1990s.

The new standard, to be implemented beginning in fiscal 2008 for many large governments, is timely given the aging demographics of the governmental work force. It also reflects the consistent efforts of the GASB to improve financial statement transparency and align public accounting more closely with that of the private sector.

GASB 45 does not increase costs of employment, but attempts to more fully reveal them by requiring governmental units to include future OPEB costs in their financial statements. Under current practice, nearly all governments pay only the cost of OPEB due in the current year, with no effort made to accumulate assets to offset future benefit costs. While not mandating funding, GASB 45 does establish a framework for prefunding of future costs.

Amounts required to prefund OPEB on an actuarially sound basis are likely to significantly exceed annual pay-as-you-go outlays for these benefits. Many actuaries believe, bolstered by preliminary studies done on behalf of a few proactive governments, that actuarially determined annual contributions could be five to 10 times higher than current expenses in many cases.

Fitch Ratings views GASB 45 as a positive step toward more fully illuminating governmental obligations to retirees, but acknowledges the inherent tension between allocating scarce resources toward critical government services today and meeting the funding requirements for retirement benefits that might not be due for decades. Fitch anticipates that governments will thoroughly review retiree benefit programs and that responses to OPEB funding challenges will vary considerably. However, Fitch expects many governments will approach GASB 45 in much the same way they responded to the adoption of pension system actuarial and accounting standards, by steadily ramping up annual contributions to actuarially determined levels, altering benefit plans, or taking other actions to ensure long-term plan solvency.

## Credit Highlights

- Governmental Accounting Standards Board (GASB) Statement No. 45 will be the accepted accounting practice for governments as of its implementation dates. Failure to comply would prevent auditors from releasing a "clean" audit opinion.
- The switch to actuarial funding from a pay-as-you-go practice may have a sizable fiscal impact. However, Fitch Ratings believes that meeting actuarial funding requirements for other post-employment benefits (OPEB) will be a stabilizing factor and protective of credit over time.
- Fitch expects a wide range of unfunded liability positions to result as GASB 45 is implemented, reflecting the variability of benefits offered around the U.S. Annually required contributions are likely to place disparate burdens on the budgetary resources of state and local governments.
- Initially, Fitch's credit focus will be on understanding each issuer's liability and its plans for addressing it. Fitch also will review an entity's reasoning in developing its plan. An absence of action taken to fund OPEB liabilities or otherwise manage them will be viewed as a negative rating factor.
- For issuers choosing to ramp up annual contributions to reach full funding of actuarially determined levels, Fitch recognizes that a rising net OPEB obligation in the short term may be a

by-product. Such an increase, taken in the context of a sound OPEB funding plan, will not by itself affect credit ratings.

- Fitch does not expect OPEB plan funding ratios to reach the generally high levels of pension systems for many years, but steady progress toward reaching the actuarially determined annual contribution level will be critical to sound credit quality.
- Assumptions play a crucial role in calculating plan assets and liabilities. As actuarial standards for OPEB plans become clear, Fitch will review the underlying assumptions and will view negatively any that are overly aggressive. When applicable, assumptions should be consistent with those adopted for the plan sponsor's pension system.
- Fitch will view OPEB liabilities, like pensions, as soft liabilities that fluctuate based on assumptions and actual experience. Reality dictates that an entity may opt to defer OPEB funding in times of budget stress. However, indefinite deferrals are damaging to credit quality. While not debt, pension and OPEB accumulated costs are legal or practical contractual commitments that form a portion of fixed costs. Long-term deferral of such obligations is a sign of fiscal stress that will be reflected in ratings.

Failure to make actuarially determined OPEB plan contributions will most likely result in rising net OPEB obligations, which like rising net pension obligations are a deferral of financial responsibility. Therefore, over time, a lack of substantive progress in funding and managing OPEB liabilities or a failure to develop a realistic plan to meet annual OPEB contributions could adversely affect an issuer's credit rating. Conversely, in Fitch's opinion, the prudent accumulation of assets in a trust account outside the general fund and well in advance of pay-as-you-go cost escalations can avoid or forestall liquidity problems or tax capacity concerns that might lead to credit deterioration.

## ■ Implementation Schedule

GASB 45 will be phased in, beginning with the largest governments, effective:

- Fiscal periods beginning after Dec. 15, 2006 for governments with annual revenue greater than \$100 million.

- Fiscal periods beginning after Dec. 15, 2007 for governments with annual revenue between \$10 million and \$100 million.
- Fiscal periods beginning after Dec. 15, 2008 for governments with revenue under \$10 million.

## ■ Exploring GASB 45

GASB 45 furthers the effort to disclose the total cost of compensation earned by public sector employees. Some of this cost, specifically the salaries and related benefits of active workers, is already recognized on the statement of revenues, expenditures, and changes in fund balance (income statement) prepared annually. Similarly, the cost of pension benefits for current and retired workers is recognized through the implementation of GASB 27, which requires income statement recognition of annual employer contributions to pension systems and balance sheet recognition of net pension obligations (most often as a liability, but theoretically an asset). GASB 45 largely adopts the accounting and

actuarial valuation methodologies used for pensions, making minor adjustments to reflect the different nature of OPEB and the reality that very few governments have funded OPEB plans.

OPEB primarily relate to retiree health care, but can also include life insurance and other benefits. OPEB contributions by employers generally take the form of direct indemnity payments or full or partial cost-sharing of annual insurance premiums, but can also take the form of an implicit subsidy. This occurs when retirees pay a health insurance premium that is based on a larger risk pool, thereby benefiting from a lower premium rate than if they had to pay the full age-based premium.

Under GASB 45, governments providing benefits to more than 200 plan members are required to have an actuarial valuation of their OPEB plans done every two years. Most governments accessing the capital markets fall under this requirement. The OPEB plan is defined as whatever constitutes the "substantive plan," incorporating written and documented plan elements, as well as nondocumented elements that have been communicated and understood between the employer and employees. The actuarial valuation determines the actuarial present value of future liabilities — in essence, the amount that, if invested at the valuation date, would be sufficient to meet all liabilities, assuming embedded assumptions hold true.

From the actuarial valuation, an annually required contribution (ARC) is determined. The ARC is the portion allocated to the current year of the amount needed to pay both the normal costs (current and future benefits earned) and to amortize the unfunded liability (past benefits earned but not previously provided for). GASB 45 requires amortization of unfunded liabilities over a maximum of 30 years.

GASB 45 requires an accounting of a government's compliance in meeting its ARC. Contributions in an amount less than the ARC result in a net OPEB obligation, which is to be recorded as a liability on the governmentwide financial statements and full accrual-based fund statements. Only the employer's payments count toward the ARC; employee matching payments do not. The direct payment of benefits counts as a contribution toward the ARC. However, since nearly all plans will have some past service liability to amortize, simply continuing with pay-as-you-go funding is likely to result in rising net OPEB obligations.

Unlike GASB 27, which covers employer accounting for pensions, under GASB 45 there will be no net OPEB obligations reported at transition (unless a government volunteers to record one). Unfunded OPEB plan liabilities will be present as governments begin to implement the standard, but governments will be required to disclose their compliance in meeting the ARC only on a going-forward basis. The footnotes to the financial statements will include information on compliance in meeting ARCs, the cumulative net OPEB obligation, and the actuarial funding ratio of the OPEB plan (assuming a trust account is established).

### ■ OPEB Trust Funds

A critical element to making OPEB plans affordable and actuarially sound is GASB 45's requirement that, in order for actuaries to permit the use of a long-term investment return assumption, governments must set aside plan assets in an irrevocable trust. Funds accumulated or earmarked but held outside an irrevocable trust are limited to an investment return assumption consistent with general government investments, which are typically shorter in duration and lower in yield. Partially funded plans are required to use a blended rate, based on the proportion of contributions being used for asset accumulation versus payment of current benefits.

The ramifications for OPEB plan valuation are enormous, as long-term return assumptions are usually at least twice those of short-term investments. The higher the investment return assumption (discount rate), the lower the present value of future liabilities and the corresponding ARC will be.

Governments and actuaries are currently exploring different types of trust mechanisms, with no clear consensus emerging to date. Options include 401(h) accounts, voluntary employee benefit accounts, section 115 governmental trusts, and others. The type of trust account used may vary depending on the design of the OPEB plan. One consideration for governments may be weighing the financial benefits of establishing a trust against the legal and human resources management implications. Many governments reserve the right to unilaterally revoke OPEB. Establishing a trust fund may be seen as conferring a permanency to the benefit plan that might not be intended.

### ■ Role of Assumptions

As they do for pension systems, economic and demographic assumptions will play a critical role in

determining the magnitude of OPEB plan liabilities (and eventually, assets). Beyond the discount rate assumption discussed in the previous section, projections of health care costs and retirement rates and ages will be crucial to OPEB plans.

Health care costs have risen rapidly since the mid-1990s, with double-digit growth rates in some years. The pace of health care cost growth outstrips the salary and general inflation assumptions embedded in pension plan valuations, making OPEB liability growth potentially more volatile. Fitch expects initial variability in medical inflation assumptions, with actuaries making adjustments over time based on experience.

Retirement rate assumptions project how many plan members will leave active service and begin collecting OPEB during the valuation period. Studies have shown that the public sector work force is disproportionately made up of baby boomers, who are nearing retirement age. The pace at which they retire will have a significant effect on liability valuations and could even affect investment performance, as plan managers may have to adjust investment allocations to maintain liquidity sufficient to meet current benefit expenses. Retirement age is also important, given the existence of Medicare. In most cases, OPEB health care costs would be at least partially offset by Medicare. However, retirement age rules vary significantly among and within governments, with some plans having to carry OPEB for 10–15 years until Medicare eligibility is reached, and others facing much shorter exposure.

### ■ Implementation Issues

GASB 45 potentially creates legal, technical, and policy issues for the public sector.

**Defining the “Substantive Plan”:** Determining the precise definition of an OPEB plan is the task of the employer, in consultation with the actuary. Written documentation of the benefit plan may or may not accurately reflect the currently understood version of the plan. Employers have a financial interest in more narrowly defining the substantive plan, which may put them at odds with employee groups. Legal challenges or labor grievances can be envisioned.

**Legal Status of OPEB:** In many states and localities, pension benefits are constitutionally protected, statutorily defined, or otherwise codified. While OPEB may have the same status in some jurisdictions, many governments have greater administrative control over OPEB. If employers seek to modify or eliminate

OPEB for some workers or retirees, legal clarification may be required.

**Medicare Part D:** The implementation of the new prescription drug benefit under Medicare is under way and scheduled to go into effect Jan. 1, 2006. Integration with government OPEB plans will take time and will be complex. It is not clear at present whether this federal program will provide a financial benefit to or impose additional costs on state and local governments.

**Labor Relations:** Faced with potentially large costs to prefund OPEB plans, governments may seek concessions from active and retired employees. Conflicts could lead to work stoppages or recruitment and retention problems. Fitch expects such difficulties to appear in the more heavily unionized areas of the country.

### ■ Potential Funding Solutions

Governments will likely explore switching employees to a defined contribution system for OPEB. Once the government makes its scheduled contribution to employees or beneficiaries, all risk is transferred to the employee. While an attractive option for employers, it is likely achievable only for new hires, as existing beneficiaries have an interest in retaining the current system. Prolonged resistance by employee groups to defined contribution pension funding underscores this difficulty.

Governments facing large unfunded liabilities and steep ARCs may consider OPEB funding bonds. However, state laws are generally not explicit regarding issuing bonds for this purpose, creating a potential impediment to capital financing for OPEB. If legally allowable, OPEB funding bonds may be structured in the same manner as pension obligation bonds, which attempt to take advantage of the interest rate differential between taxable municipal bonds and the assumed investment return on plan assets. Bonds could be issued to fund all or a portion of a sponsor's unfunded OPEB liability, with the hope that the debt service on the bonds would be less than what the sponsor would otherwise have to pay in annual OPEB ARC costs over the long term.

Fitch believes that OPEB funding bonds, if used moderately and in conjunction with a prudent approach to investing the proceeds and other plan assets, can be a useful tool in asset-liability management. However, a failure to follow balanced and prudent investment practices could expose the plan sponsor to market losses.

Because a sponsor's unfunded OPEB liability will be factored into the rating, bond issuance would simply move the obligation from one part of the governmentwide or full accrual-based fund financial statements to another. However, Fitch notes that OPEB or pension funding bonds create a true debt, one which must be

paid on time and in full, rather than a softer liability that can be deferred or rescheduled from time to time during periods of fiscal stress. Consequently, issuing bonds to fund an OPEB plan could have a significant effect on financial flexibility over time.

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**MEMORANDUM**

December 1, 2006

TO: County Council

FROM: Stephen B. Farber, Council Staff Director *SBF*

SUBJECT: Overview of Economic Indicators and the FY08-13 Fiscal Plan

This overview of economic indicators and the FY08-13 Fiscal Plan is a precursor to Council action, scheduled for December 12, on fall spending affordability guidelines for the FY08 operating budget. The Management and Fiscal Policy Committee reviewed these reports on November 27.

**Economic Indicators**

Finance Director Tim Firestone, Treasury Division Chief Rob Hagedoom, and Chief Economist David Platt briefed the Committee on recent national, regional, and County economic data. They discussed the graphs and charts on C1-26.

The national indicators continue to present a generally positive picture, but evidence of a slowdown persists. Real gross domestic product rose at a rate of 2.2 percent in the third quarter, down from 5.6 and 2.6 percent in the first and second quarters. The key factor is the continued decline in residential fixed investment. While the stock market has rebounded firmly since mid-August, long-term interest rates have eased, and the price of oil has retreated sharply from its peak, the housing sector continues to cool.

The regional economy remains one of the nation's strongest, but it too is moderating. For counties nationwide of at least 250,000 people, the top ten for median household income include Loudon, Fairfax, and Howard as 1<sup>st</sup>-3<sup>rd</sup> and Montgomery and Prince William as 6<sup>th</sup>-7<sup>th</sup>. Payroll employment continues to grow, but home prices have softened. Year-over-year core inflation was up 3.7 percent in September, but the overall CPI increase slowed from 4.6 percent in May to 2.8 percent in September because of the decline in energy prices. Some regional analysts project that priorities of the new Congress may lead to slower growth for defense, homeland security, and pharmaceutical firms and the office rental market.

County economic indicators are generally positive – the unemployment rate is just 2.7 percent and employment growth has been strong – but residential construction continued its steady decline, with starts this year down 29 percent. Home sales through October were down nearly one-fourth compared to 2005, to the lowest level since 1998. Average home prices were up 6.1 percent through October compared to 2005 but were flat for the July-October period.

The summary on ©26 highlights these national, regional, and County trends and lists several “early alerts” for policymakers to consider.

### **FY08-13 Fiscal Plan .**

OMB Director Beverley Swaim-Staley and Operating Budget Coordinators Alex Espinosa and Beryl Feinberg, as well as Messrs. Firestine, Hagedoorn, and Platt, joined the Committee to review the first edition of the FY08-13 Fiscal Plan. See ©27-71.

The Committee has collaborated with OMB and Finance to develop and refine fiscal projections since 1993 and has reviewed updated editions each spring and fall since then. There has been continuous improvement in how best to display such factors as economic and demographic assumptions, individual agency funds, major known commitments, illustrative expenditure pressures, gaps between projected revenues and expenditures, and productivity improvements. The agencies have also worked to harmonize their fiscal planning methodologies. It is important to note that each edition of the **Fiscal Plan** reflects a snapshot in time, and that with each edition the picture will change.

### **Current Edition (November 2006)**

Points of special interest include the following:

1. The most important changes in the revenue summary on ©28 are for **income tax and transfer and recordation taxes**. The current estimate for income tax is **\$106.5 million more** than the May 2006 estimate for the FY07 approved budget. The current estimate for transfer and recordation taxes is **\$50.5 million less** than the May estimate. These changes reflect the strength of the job and stock markets and the weakness of the housing market. The current estimate for these revenues in FY08, compared to the May estimate, also reflects these changes: **\$133.7 million more** for income tax and **\$38.3 million less** for transfer and recordation taxes.

2. The key page in this presentation is the **Fiscal Plan Summary** on ©32. The list of selected assumptions for expenditures on ©31, including three tiers, is clear and well crafted. So is the list of footnotes on ©33.

- **Tier 1** on ©32 assumes that agency expenditures in FY08 will rise by **7.3 percent**, the 10-year average historical rate of growth. This is a more realistic number than the 6.3 percent used in the April 2006 edition of the Fiscal Plan, but the experience of recent years suggests that it is still too low.

• **Tier 2** includes the incremental cost for a five-year phase-in of the accrual standard for retiree group insurance. (GASB 45 requires disclosure of this cost. The Committee reviewed this issue, including pre-funding, with the agencies on November 27.) The incremental cost, \$31.9 million in FY08, rises steadily to \$187.7 million in FY12.

• **Tier 3** reflects property tax at the Charter limit.<sup>1</sup> Compared to current rates, the Charter limit would mean a revenue reduction of \$159.3 million in FY08 (or slightly less, depending on how the reduction is designed). But as Mr. Andrews noted on November 27, **even at the Charter limit, property tax revenue would be \$43.9 million or 3.8 percent more than in the FY07 approved budget.**

**Nonetheless, a revenue reduction of \$159.3 million would have a large impact on the FY08 budget process.** The Fiscal Plan Summary on ©6 suggests that a workable design for the FY08 budget can be crafted with revenues as currently projected, *including property tax at current rates*. This is so even if the first year phase-in cost for GASB 45 is included. **But property tax at the Charter limit produces a gap of \$173.7 million.**

On the other hand, continuation of current rates, given the rise in assessments of recent years, would result in an increase in homeowners' property tax bills of **10 percent**, the County's cap on increases in taxable assessments.

**To illustrate the impact of meeting the Charter limit in FY08**, Mr. Sherer's initial calculation for the fall spending affordability guidelines for the FY08 operating budget shows that assuming (a) the Charter limit, (b) the first-year phase-in of GASB 45 expense, (c) Finance's revised revenue estimates, and (d) maintenance-of-effort increases (only) for MCPS (2.4 percent) and the College (4.0 percent), the increases available for County Government and M-NCPPC would be just 1.8 percent each.

Another key aspect of Tier 3 is the **out-year impact** of the Charter limit. Since the base for computing the limit declines (from what it would be at current rates) each time it is met, the revenue loss, compared to current rates, grows sharply over time – to **\$657.1 million** in FY13. As a result, the gap in FY13, if the Charter limit is met each year until then, grows to **more than \$1 billion**.

### **3. With regard to revenues, two additional points are worth making:**

- The assumption for FY08-13 is that the tax increases (on income, energy, and telephones) approved to deal with budget challenges in FY04-05 will remain in place.

<sup>1</sup>The Charter limit, approved by County voters in 1990, permits annual growth in County property tax revenue from existing real property to increase only by the rate of inflation. The limit does not apply to revenue from new construction, several more minor factors, or personal property. The Council may exceed the Charter limit with a supermajority of 7 affirmative votes, but no criteria, such as emergency conditions, are specified for doing so. The understanding in 1990 between Councilmembers who sponsored the amendment and Robert Denny, head of Fairness in Taxation, which had advocated a stricter alternative, was that this flexibility would enable the Council to deal with serious fiscal challenges over time. The Council voted to adhere to the Charter limit in FY92-02, exceed it in FY03-05 (by \$4 million, \$29 million, and \$48 million, respectively), and adhere to it in FY06-07.



# County Executive's Recommended FY08-13 Public Services Program Tax Supported Fiscal Plan Summary

(in millions)															
	App FY07	Est. FY07	% Chg. FY07-08 Revised	% Chg. FY07-08 Budget	Rec FY08	% Chg. FY08-09	Projected FY09	% Chg. FY09-10	Projected FY10	% Chg. FY10-11	Projected FY11	% Chg. FY11-12	Projected FY12	% Chg. FY12-13	Projected FY13
Total Resources															
Revenues	3,371.5	3,379.3	12.2%	10.2%	3,725.6	6.3%	3,959.0	5.7%	4,186.4	6.8%	4,469.3	6.0%	4,736.8	6.2%	5,031.3
Beginning Reserves Undesignated	233.4	237.4	-50.9%	-51.7%	114.7	-5.9%	107.9	11.2%	120.0	11.8%	134.1	12.1%	151.7	11.3%	168.8
Beginning Reserves Designated	2.6	2.8	840.8%	840.8%	18.7	-78.5%	4.0	16.1%	4.7	7.3%	5.0	6.8%	5.4	0.0%	5.4
Net Transfers In (Out)	24.6	24.6	2.9%	2.9%	25.4	2.8%	26.1	2.7%	26.8	2.7%	27.5	2.6%	28.2	2.6%	28.9
Total Resources Available	3,682.4	3,644.2	8.4%	6.6%	3,884.4	5.5%	4,097.0	5.9%	4,337.9	6.9%	4,635.9	6.7%	4,922.0	6.3%	5,234.3
Less Other Uses of Resources (Capital, Debt Service, Reserve)	406.9	464.9	12.1%	-1.9%	456.1	2.1%	465.6	3.7%	482.7	2.2%	493.4	5.3%	519.7	3.6%	538.4
Available to Allocate to Agencies	3,175.5	3,179.3	8.0%	7.8%	3,428.3	5.9%	3,631.4	6.2%	3,855.1	7.3%	4,142.4	6.3%	4,402.3	6.7%	4,695.9
Agency Uses															
Montgomery County Public Schools (MCPS)	1,724.4	1,724.6	7.3%	7.3%	1,882.4	7.3%	1,993.1	7.3%	2,129.6	7.3%	2,284.6	7.3%	2,450.9	7.3%	2,629.4
Montgomery College (MC)	180.2	180.2	8.4%	8.4%	195.2	8.4%	211.6	8.4%	229.2	8.4%	248.4	8.4%	269.2	8.4%	291.7
MNCPFC (w/o Debt Service)	89.5	89.7	8.1%	4.9%	94.1	4.9%	98.7	4.9%	103.4	4.9%	108.7	4.9%	114.0	4.9%	119.4
MCC	1,181.3	1,184.6	7.6%	7.3%	1,271.1	7.3%	1,343.9	7.3%	1,443.4	7.3%	1,570.3	7.3%	1,684.9	7.3%	1,807.9
Subtotal Agency Uses	3,175.6	3,179.3	7.4%	7.3%	3,419.8	7.3%	3,639.2	7.3%	3,926.8	7.3%	4,212.0	7.3%	4,519.0	7.3%	4,848.6
Subtotal Other Uses of Resources (Capital, Debt Service, Reserve)	406.9	464.9	12.1%	-1.9%	456.1	2.1%	465.6	3.7%	482.7	2.2%	493.4	5.3%	519.7	3.6%	538.4
Total Uses	3,582.4	3,644.2	7.9%	6.1%	3,866.8	6.7%	4,124.8	6.9%	4,408.6	6.7%	4,705.4	7.1%	5,036.7	6.9%	5,387.0
Tier 1															
(Gross) Available at a 10 year average historical rate of growth	0.0	0.0			17.8		(27.8)		(70.7)		(69.4)		(116.7)		(192.7)
Tier 2															
GASB 48 5 Year Phase-In	0.0	0.0			(31.9)		(70.7)		(109.8)		(148.9)		(187.7)		(197.1)
Tier 3															
Property Tax @ PIT	0.0	0.0			(159.3)		(242.2)		(320.8)		(435.2)		(535.8)		(657.1)
(Gross) Available	0.0	0.0			0.0		0.0		0.0		0.0		0.0		0.0
(Gross) Available	0.0	0.0			(173.7)		(346.7)		(561.3)		(653.4)		(840.2)		(1,006.8)

1. FY07 Estimate reflects preliminary unaudited beginning fund balance.

## County Executive's Recommended FY08-13 Public Services Program Tax Supported Fiscal Plan Summary Assumptions

### Tier 1:

1. Projected Agency Uses for FY08-13 for all agencies are based on the average annual rate of growth for FY98-07 (10-year).

c) Additional State and Federal aid are assumed at current formulas.

b) All revenues are projected at current rates.

2. The labor contracts will expire as follows:

a) MNCPPC's contract with MCGEO expires at the end of FY09.

b) The MCG contracts with the County Fraternal Order of Police (FOP) Lodge #35 and Municipal and County Government Employees Organization (MCGEO) Local 1994 will expire at the end of FY07.

c) The Board of Education's contracts with the Montgomery County Education Association, Montgomery County Council of Supporting Services Employees, and the Montgomery County Association of Administrative and Supervisory Personnel (MCAASP) will expire at the end of FY07.

d) The County's contract with the International Association of Firefighters (IAFF) Local 1664 expires at the end of FY08.

### Tier 2:

3. Tier 2 includes the estimated cost of compliance with GASB 45, 5-year phase-in approach to pre-funding post-employment group insurance benefits.

### Tier 3:

4. Tier 3 shows the impact on property tax revenue at the Charter Limit.

OTHER POST-EMPLOYMENT BENEFITS  
SURVEY OF LARGE-POPULATION 'TRIPLE AAA' COUNTIES  
Montgomery County Department of Finance - APRIL 2007

County	State	Population (2004)	Moody's	S&P	Fitch	Actuarial Valuation Completed?	As of Date	Total AAL	Total ARC	Trust Created?	Balance of Trust	Do They Plan to Pre-fund?	Any Pre-funding yet?	Programmed for 2008 & future years?	Phase-in over how many years?
Baltimore	MD	781,171	Aaa	AAA	AAA	Yes	1-Jul-06	\$2.55 bln	\$228.2 mln	Yes	\$169.4 mln	Yes	Yes	Yes	4-5 years
Of Note: Beginning in FY 07 the County will no longer provide health care benefits to retirees with less than 10 years active service.															
DuPage	IL	928,126	Aaa	AAA	AAA	No	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Of Note: County is reimbursed 100% of retiree health insurance premiums by the retirees, thus no OPEB cost in FY 05. They may have OPEB liability due to active vs. retiree implicit rate subsidy.															
Fairfax	VA	1,035,051	Aaa	AAA	AAA	Yes	2006	\$191 mln	\$16 mln	No	N/A	N/A	N/A	N/A	N/A
Of Note: County pays a monthly subsidy to retirees with at least five years of service. Subsidy ranges from \$15 to \$175 per month, based upon years of service. FY06 OPEB expenditures (PAY GO basis) were \$4.247 million.															
Hennepin	MIN	1,119,866	Aaa	AAA	AAA	Yes	1-Jan-06	\$280.0 mln	\$28 mln	No	N/A	N/A	N/A	N/A	N/A
Of Note: Upon reaching age 65 (Medicare eligibility), retirees are not provided with healthcare benefits; future retiree benefits cuts are planned, thus reducing AAL.															
Mecklenburg	NC	771,573	Aaa	AAA	AAA	No	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Of Note: County pays 100% of health insurance premiums for retirees with 20+ years of active service; 50% for those with 10-19 years service. FY 06 OPEB expense = \$2.327 million. Per CAFR: "The County ... [is] under no statutory requirement to provide this benefit. Consequently, there is no unfunded liability to the County ... for this benefit."															
MONTGOMERY	MD	921,631	Aaa	AAA	AAA	Yes	1-Jul-06	\$2.6 bln	\$240.0 mln	1-Jul-07	\$31.9 mln	Yes	No	Yes	5 years
Of Note: County's intent is to establish a trust on July 1, 2007, with initial funding of \$31.9 million.															
Palm Beach	FL	1,244,189	Aaa	AAA	AAA	No	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Of Note: Limited number of retirees receive benefits; FY 05 OPEB expenditures = \$1.393 million.															
St. Louis	MO	1,007,723	Aaa	AAA	AAA	No	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Of Note: County is in beginning stages of OPEB actuarial valuation.															
Salt Lake	UT	934,838	Aaa	AAA	AAA	No	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Of Note: Health insurance premium share paid by retirees is based on years of service, with a minimum of four years service to be eligible for benefits. Subsidy reduced when retiree reaches age 65. 2005 expenditures for post-retirement health care (PAY GO basis) were \$1.926 million.															
OTHER COUNTIES															
Anne Arundel	MD	508,572	Aa1	AA+	AA+	Yes	2006	\$1.27 bln	\$117.6 mln	No	N/A	N/A	N/A	N/A	N/A
Of Note: County pays 80% of the cost for medical coverage of retirees. Retirees must pay the full cost of dental and vision coverage.															
Carroll	MD	166,489	Aa2	AA	AA+	Yes	FY08	\$98.2 mln	\$10.3 mln	FY08	\$0	Yes	No	Yes	5 years
Of Note: FY06 OPEB expenditures (PAY GO basis) were \$1.8 million.															
Howard	MD	268,561	Aaa	AAA	AAA	Yes	Aug-06	\$476.6 mln	\$53.2 mln	No	N/A	Yes	No	No	5 years
Of Note: In order to be eligible, the retiree must have a minimum of ten years of County service. The County will make minor changes to the OPEB benefit as soon as it is practicable and this will reduce OPEB liability.															
Prince George's	MD	841,642	Aa2	AA+	AA+	Yes						Yes	No	Yes	10 years
Of Note: FY06 OPEB expenditures (PAY GO basis) were \$18.0 million; proposed FY 08 OPEB funding is \$31.0 million.															

AAA Counties OPEB to Council

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